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MINING RECLAMATION RESERVES AND COAL AND IRON ORE DEPLETION

HEARING

BEFORE THE

SUBCOMMITTEE ON
ENERGY AND AGRICULTURAL TAXATION

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

S. 237 and S. 1006

MAY 23, 1983

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MINING RECLAMATION RESERVES AND COAL AND IRON ORE DEPLETION

MONDAY, MAY 23, 1983

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION,
Washington, D.C.

The subcommittee met, pursuant to notice, at 1:30 p.m., in room SD-215, Dirksen Senate Office Building, Hon. Malcolm Wallop (chairman of the subcommittee) presiding.

Present: Senators Wallop, Symms, and Heinz.

[The committee press release and the opening statements of Senators Wallop and Symms follow:]

[Press Release]

FINANCE SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION SETS HEARING ON MINING RECLAMATION RESERVES AND COAL AND IRON ORE DEPLETION

Senator Malcolm Wallop, Chairman of the Subcommittee on Energy and Agricultural Taxation of the Senate Committtee on Finance, announced today the Subcommittee will hold a hearing on Monday, May 23, 1983, on S. 237, Senator Wallop's bill which deals with the tax treatment of mining reclamation reserves, and S. 1006, Senator Specter's bill which would repeal the 15 percent in percentage depletion for coal and iron ore.

The hearing will begin at 1:30 p.m. in Room SD-215 of the Dirksen Senate Office Building.

In announcing the hearing, Senator Wallop expressed the importance of both bills to the mining industry: "S. 237 is designed to end the sparring between the surface mining industry and the IRS on the accrual of reclamation expenses. S. 1006 would repeal the 15 percent reduction in the percentage depletion allowance for coal and iron ore. The 15 percent reduction, which will go into effect at the end of this year, could not come at a worse time. When so much of our heavy industry is fighting for survival, the reduction in the ability to deduct legitimate expenses incurred by the mining industry can only make that fight that much more difficult."

OPENING STATEMENT OF SENATOR MALCOLM WALLOP

The purpose of this afternoon's hearing is to receive testimony on two bills which are of great importance to the continued economic wellbeing of the mining industry. The first bill is S. 237, which I introduced earlier this year and which is essentially identifical to legislation I along with Senator Symms introduced in the last Congress. The second bill, S. 1006, introduced by Senator Specter would repeal the scheduled reduction in the percentage depletion allowance for coal and iron ore production.

With respect to S. 237, this will be the second time in less than six months that the Treasury Department will have the opportunity to comment on the current enforcement posture shared by them and the IRS with regard to accrued mining reclamation expenses. As Treasury's testimony last December did not express an opinion consistent with that shared by the tax court or myself for that matter, I believe that it is only fair that we give the Treasury Department a second chance to see the

error of their ways. I suspect however, that the Treasury Department is hoping for the same sort of reform on my part. It is therefore, reasonable to assume that both of us will leave this hearing somewhat disappointed.

I will touch just briefly on what is at issue here with respect to mining reclamation expenses, and rely on our expert witnesses to provide a more detailed analysis. The fundamental question revolves around the conditions set forth in the regulations which accompany section 461 of the tax code. Those regulations clearly state that for a taxpayer using the accrual method of accounting, "an expense is deductible for the taxable year in which all events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy." This test set forth in the regulations is generally referred to as the "all events" test. The mining industry does not take issue with that "all events" test, and indeed the tax court in the *Ohio River Collieries* case last year, determined that accured mining reclamation expenses fit within the requirements of the "all events" test, and that a current deduction should be allowed for accured mining expenses. I am sure that Treasury will not take issue with the fact that a mining reclamation liability accrues just as soon as the ground is distributed as a part of the mining process. However, Treasury will take issue with the fact that it can be reasonably estimated. This position is taken in light of the fact that every state that I am aware of requires that a mine operator post a performance bond to guarantee that the reclamation work is done. In states like my home state of Wyoming the amount of the performance bond must be updated on a yearly basis. The sophistication of engineering analysis done by mining companies in computing this reclamation liability has clearly established that the liability can be determined with "reasonable" accuracy.

Last year, the Treasury Department went beyond what its own regulations call for in suggesting that in this type of situation some mechanism should be developed which would take into account the time value of money—a discount rate which would roughly equate the value of the deduction to the time the expense for the reclamation is actually incurred. While that concept, if carried to its logical conclusion, could easily added several hundred new pages to a tax code which is already several thousand pages too long, it raised in my mind a more fundamental question—one which I am sure could put the Treasury Department on the front page of every financial publication in the country for several days. Is the Treasury Department suggesting that we eliminate the accrual method of tax accounting and instead require that every taxpayer file their annual income tax return on a "cash basis"? I agree that such a position would vastly simplify the tax code, but I am sure it would cause advocates of what is known as the "matching" principle some cause for concern. Indeed, those accounting principles and economic common sense all tell us, before a profit can be determined, all expenses associated with the income-producing activity must be taken into account. Needless to say I will be most interested in the Treasury Department's further comments.

As I mentioned earlier, we will also be considered S. 1006 which has been introduced by Senator Specter. I support and have cosponsored the legislation. Many of you will recall that last year when the Finance Committee was considering the tax bill, I opposed Committee action which I applied the reduction in the percentage depletion allowance to coal and iron ore. My minority view filed with the Committee's report echoed that opposition. On the floor of the Senate, I joined with Senator Specter in gaining a one year delay in the scheduled percentage depletion reduction. I have not seen any significant change in the coal and iron ore industry that leads me to believe that the scheduled reduction is any more appropriate now that it was then. I believe the permanent elimination of the reduction called for in Senator Specter's bill is not only appropriate but necessary.

It is my hope that the testimony we receive today from the Treasury Department will reflect not only the need for the certainty business requires when trying to make long-term business decisions, but also the current economic situation of the mining industry and the impact these bills can have on that situation.

Opening Statement by Senator Steve Symms

Good afternoon. I would like to take this opportunity to thank the Chairman of this Subcommittee, Senator Wallop, for holding this hearing today on two issues which are of vital importance to the American mining industry.

I am particularly grateful for the Chairman's continuing interest in pursuing the Comprehensive Mining Reclamation Reserve Act of 1983. S. 237 would solve the long-running dispute between the mining industry and the Internal Revenue Service which began when the IRS issued a revenue ruling in 1978 which sought to re-

verse the manner in which operators had been accounting for their reclamation expenses.

Hopefully, the Committee will act quickly on this legislation. It always seems nonsensical to me that our Government continues to make it difficult for the producers in our economy to function. This Committee is continually having to correct the activities of the IRS through legislation, when the Service often has no justification for trying to legislate through regulation. It seems to me that the Government should start harassing the non-producers in our economy—those who are illegally accepting benefits from the public dole for which they are not eligible.

With regard to S. 1006, legislation offered by Senator Specter, I am pleased to lend my support to his efforts. It was regretful that during the consideration of TEFRA it was not possible to exclude all hard rock minerals, including iron ore and coal, from the minimum corporate tax percentage depletion preference item. However, because of the revenue involved, it was not possible to exclude coal and iron ore along with all of the other hard-rock minerals. I am hopeful that this matter can be favorably resolved in the future and that all hard-rock minerals receive the same capital gains treatment as well.

Senator WALLOP. The subcommittee will convene this afternoon to receive testimony on two bills which are of great importance to the continued economic well-being of the mining industry. The first bill is S. 237, which I introduced earlier this year and which is essentially identical to legislation I, along with Senator Symms, introduced in the last Congress.

The second bill, S. 1006, introduced by Senator Specter, would repeal the scheduled reduction in the percentage depletion allowance for coal and iron ore production.

With respect to S. 237, this will be the second time in less than 6 months that the Treasury will have the opportunity to comment on the current enforcement posture shared by them and the IRS regarding accrued mining reclamation expenses. As Treasury's testimony last December did not express an opinion consistent with that shared by the Tax Court or by me, for that matter, I believe that it is only fair that we give the Treasury a second chance to see the error of their ways.

I suspect, however, knowing them as I do, that Treasury is hoping for the same sort of reform on my part. It is, therefore, reasonable to assume that each of us will leave this hearing somewhat disappointed.

Let me just touch briefly on what is at issue here with respect to mining reclamation expenses and rely upon our expert witnesses to provide a more detailed analysis. The fundamental question revolves around the conditions set forth in the regulations which accompany section 461 of the Tax Code.

Those regulations clearly state that for a taxpayer using the accrual method of accounting, "An expense is deductible for the taxable year in which all events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy."

This test, set forth in the regulations, is generally referred to as the all-events test. The mining industry does not take issue with that all-events test, and indeed the Tax Court in the *Ohio River Collieries* case last year determined that accrued mining reclamation expenses fit within the requirements of the all-events test and that a current deduction should be allowed for accrued mining expenses.

I am certain the Treasury will not take issue with the fact that a mining reclamation liability accrues just as soon as the ground is

disturbed as a part of the mining process. However, I expect they will take issue with the fact that it can be reasonably estimated. This position is taken in light of the fact that every State that I am aware of requires that a mine operator post a performance bond to guarantee that the reclamation work is done.

In States like my State of Wyoming, the amount of the performance bond must be updated on a yearly basis. The sophistication of engineering analysis done by mining companies in computing this reclamation liability has clearly established that their liability can be determined with reasonable accuracy.

Last year the Treasury Department went beyond what its own regulations called for in suggesting that in this type of situation some mechanism should be developed which would take into account the time value of money, a discount rate which would roughly equate the value of the deduction to the time that the expense for the reclamation is actually incurred.

Well, that concept, if carried to its logical conclusion, could easily add several hundred new pages to a Tax Code already several thousand pages too long, and it raised in my mind at least more fundamental questions, ones which I am sure could put the Treasury Department on the front page of every financial publication in this country for several days.

Is the Treasury Department suggesting that we eliminate the accrual method of tax accounting and instead require that every taxpayer file annual income tax return on a cash basis? I would agree that such a position would vastly simplify the Tax Code, but I am sure it would cause advocates of what is known as the matching principle some cause for concern.

Indeed, those accounting principles and economic commonsense all tell us that before a profit can be determined all expenses associated with the income-producing activities must be taken into account. Needless to say, I am most interested in Treasury's comments as to this potential elimination.

As I mentioned earlier, we will also be considering S. 1006, which has been introduced by Senator Specter, which I support and have cosponsored. As many of you recall, last year when the Finance Committee was considering a tax bill I opposed committee action which applied the reduction in the percentage depletion allowance to coal and to iron ore. In a minority view filed with the committee report I echoed that position, and on the floor of the Senate I joined with Senator Specter in gaining a 1-year delay in the scheduled percentage depletion reduction.

I have not seen any significant change in the coal or the iron ore industry that leads me to believe that the scheduled reduction is any more appropriate now than it was then. I would believe that the permanent elimination of the reduction called for in Senator Specter's bill is not only important but necessary, and it is my hope that the testimony received from the Treasury Department today will reflect not only the need for the certainty business requires when trying to make long-term business decisions, but also the current economic situation of the mining industry and the impact that these bills can have on that situation.

The first witness is Bill McKee, Acting Deputy Assistant Secretary for Tax Policy. Welcome this afternoon.

STATEMENT OF WILLIAM S. McKEE, ACTING DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. McKEE. Thank you, Mr. Chairman.

I am pleased to have the opportunity to present the views of the Treasury Department on S. 237, which would permit both cash and accrual method taxpayers to deduct the estimated cost of surface mining reclamation work in a taxable period prior to the year such work is performed, and S. 1006, which would repeal the 15-percent corporate tax preference reduction in the percentage depletion allowance for coal and iron.

For reasons I will discuss, Treasury is strongly opposed to both these bills. Turning first to S. 237, as you noted, Treasury testified last year on two similar bills. Since our position has not changed, I will make my remarks more brief than usual.

The issue is whether or not surface mine operators who are required to restore land damaged in the mining process should be able to deduct the restoration cost when the damage has occurred or only when there is a present liability to pay for the reclamation work. The Tax Court has recently held in the *Ohio River Collieries* case that an accrual method taxpayer could deduct the estimated future cost of mining reclamation expenses in the year of the mining operation, even though the reclamation work has not started and the taxpayer has no present liability to pay for the work.

S. 237 would codify the Tax Court's decision for accrual method taxpayers and extend it to cash basis taxpayers. The mechanics used to achieve this result are set forth in my written statement.

The problem addressed by S. 237 is not without surface appeal. As you noted, true profit requires offsetting income by all expenses incurred to produce that income. But there are three reasons for not allowing the current deduction of future expenses:

First, giving a deduction today for tomorrow's expense overstates the deduction to the extent that it fails to take into account the time value of money, as you pointed out.

Second, such a rule is hard to administer, since any estimate of future expense is necessarily uncertain.

Third and perhaps most importantly, the revenue loss from such a rule applied evenhandedly to all similarly situated taxpayers would be prohibitive.

The overstatement of the deduction is addressed at length in the testimony and the appendix thereto. Simply put, if the future cost of reclaiming the land is $100, say, in year No. 7, giving a taxpayer a deduction of $100 today fails to account for the fact that the taxpayer does not part with any cash for 6 years. The $50 tax savings in year No. 1, assuming a 50-percent-bracket taxpayer, can grow, if we assume a 12-percent interest rate, to $100, which is enough to pay the expense total courtesy of the tax system.

We acknowledge the taxpayer may not have enough income in year No. 7 to use the deduction if we put off the deduction until year No. 7, as we propose as the correct answer. The solution, however, to that is to extend the net operating loss carryback rule period, as is the case under current law for product liability losses.

S. 237's reserve accounting rule is similar to that of section 462, which was enacted in 1954 and repealed retroactively in 1955. Esti-

mates of future liabilities are difficult and the revenue cost, as quickly seen in 1955, of such a rule was enormous.

We feel that the principle of S. 237 would logically lead to a reenactment of rules similar to that as section 462 of the 1954 Code and we simply do not think that either the Congress and certainly not the Treasury is prepared to withstand those kinds of revenue losses.

In sum, we simply disagree with the *Ohio River Collieries* case. We think that in terms of litigating the case the Government made a mistake when it conceded the factual issue as to the accuracy of the estimate of the future expense liability. We also disagree, however, with the legal conclusion of the court. We think that you need a present liability to pay an expense to be entitled to accrue that expense.

If legislation is in fact called for, which perhaps it is, we think that legislation should confirm the Internal Revenue Service's view, rather than the view of the Tax Court in *Ohio River Collieries,* for the reasons that I have expressed.

Incidentally, in no case can we see any reason to extend the rule to a cash-method taxpayer.

Senator, I think you are correct to say that there are some serious problems in this area and that they do need to be addressed, and we are not proposing that the accrual method of accounting be repealed. Nevertheless, I think it is fair to say that we believe that we should work with you and the Finance Committee to explore possible abuses in the accrual method of accounting, not only as applied in this case but in many other cases.

We have noticed with increasing regularity that taxpayers are designing transactions so that the present tax deduction of a future expense produces a tax savings which, when invested, is more than enough to pay the expense and in some cases will even earn a profit for the taxpayer in terms of after-tax dollars.

In other words, we have discovered situations in which the taxpayer is actually better off to incur the future expense so that he may currently deduct the amount, invest the tax savings, and end up making a profit courtesy of the tax system.

Turning now to——

Senator WALLOP. That might not be in the mining industry. That might be in the insurance industry, which I understand causes you problems. But you would not suggest that was the case in the mining industry, would you?

Mr. MCKEE. It depends upon the length of time between the taking of the deduction and the paying of the expense. It would be possible in the mining industry if there were a long enough time period between the two, assuming that the miner was in the 50-percent tax bracket, which if he were a profitable corporation he would be.

Senator WALLOP. We are only talking about the mining industry in this bill, as we were a year ago. We would be happy to work with you on the other problems that you have identified outside the mining industry. But it seems to me that you are subject to those other problems right now, and by hiding your head in the sand and hoping that nobody raises *Ohio River Collieries* and chal-

lenges you on that basis, you are inviting the very kind of result that you seek to avoid by opposing this bill in the other instances.

Mr. McKee. Senator, I think our view is that the problem raised by *Ohio River Collieries* is severe, but we disagree with the court in terms of its technical reading of the law. We admit we lost the case in the Tax Court and we intend to continue to litigate it.

Senator Wallop. Last year you were not. You are now?

Mr. McKee. It is my understanding that we were last year, too. The Service I think is going to continue to fight that.

Senator Wallop. I am not sure. I may be wrong, but I thought last year that the testimony was that you had not decided to contest that.

Mr. McKee. That may be the case. I will have to confirm that, Senator, as to whether or not we are going to continue. We are certainly going to continue to litigate the issue outside of the mining reclamation area, in terms of current deductions for product warranty losses, et cetera. We have a hard time with carving out one industry for a special rule and not applying that to other industries.

Senator Wallop. Well, I understand that in a general sense, but there are certain conditions that apply to the mining industry that do not apply other places. I mean, the first and foremost of those, I have to disagree with you that they do not have a present liability. Once they break a shovelfull of ground, they have a liability which will not go away.

If they go broke, they still have that liability and it will be taken out of whatever bond they have posted. And if that is not the case, that is a high standard that they have to meet in bankruptcy court.

But let me reverse this a minute and if you do not mind let us talk about this bill and then we will go on to S. 1006. Your complaint is on the one hand that the Government loses the time value of the money, and you say that their remedy is in an operating loss carryback. Who then loses the time value of money?

Mr. McKee. The taxpayer does not lose the time value of money in my example. If he pays to repair the land in year No. 7 and he pays it in year No. 7 dollars, when he actually comes out of pocket with the cash he gets his $100 deduction.

If it turns out that he does not have enough income to be able to fully utilize the value of that deduction, we propose to give him a longer carryback period so that he can get an immediate tax refund from the Government. We acknowledge that if we force him to carry the deduction forward then he does lose the time value of money, because going forward in year 8, 9, 10 he loses the value of the deduction as time erodes it.

But as long as, assuming the 50-percent bracket, that in year No. 7 when he pays $100 he gets a $50 tax benefit, he is made whole.

Senator Wallop. Is there any other section of the Tax Code that requires the taxpayer to take into account the time value of money?

Mr. McKee. Again, Senator, we are not proposing here a rule that takes it into account. We are objecting to the results that are being reached under the bill because of the policy concern that it fails to take it into account.

Senator WALLOP. The interpretation is the same as the rule. You are not proposing a rule. It is just that, by saying that that is the case in the two-pronged test, you are in effect making a rule. And all I am suggesting or asking you is if there is any other segment or section of the Tax Code which requires a taxpayer to take into account the time value of money.

Mr. MCKEE. Yes. In the insurance provisions, the reserves for future liabilities in the life insurance area are discounted to present value by certain assumed rates. In our testimony dealing with life insurance, we objected that the discount rates used were too low. But we do note that the deduction that the life insurance industry is entitled to take is reduced from its nominal value to a present value by an assumed rate, which is generally the rate set by State law commissioners.

Senator WALLOP. What would there be to prevent you from doing the same thing in the mining industry? There would certainly be a better circumstance than they presently are faced with.

Mr. MCKEE. Well, I am not sure that the mining industry would be interested in accepting a deduction today of the present value of the future expense. We note the problems that we are having with the insurance industry.

Senator WALLOP. Well, is it not best for them to answer?

Mr. MCKEE. Well, we have discussed it with them and they were not too interested.

But let me just say that one of the biggest problems in the Tax Code with those kinds of rules is that you have to put in a discount rate, and the argument we are having, one of the arguments we are having with the insurance industry or one of the disputes is what is the appropriate discount rate.

We would get into a similar dispute with the industry here. However, it is possible that—we are interested in exploring this issue, not only in the mining area but in a number of other areas, and that maybe the Congress chooses to move in that direction. We think there are a number of alternatives that we would like to explore to deal with what we think is one of the most serious problems in the tax law.

Senator WALLOP. Well, under the present value concept is the Department thereby indicating a willingness to discount income that is to be received in the future, although currently taxable under law?

Mr. MCKEE. Well, I think that we would certainly have to be symmetrical in our treatment if we moved into the area of trying to deal with either income items that are accrued or deduction items that are accrued.

I am not suggesting, Senator, that this is an easy one. I emphasize, we would like to work with your staff to try to come up with some answers. We just emphasize that if you move in this direction here you are going to find similarly situated taxpayers coming in and asking for equal treatment, and if we are not careful we are going to be right back to section 462 of the 1954 Code, and I do not think any of us wants to be there.

Senator WALLOP. No, I agree. But I think we can deal with that in this legislation if you would only express the willingness to. But it seems to me that if you are recognizing the necessity of symme-

try, that the thing to do would be to achieve the symmetry before proceeding, rather than to create an asymmetrical interpretation on the prospect that at some future time you might deal with the income side of the ledger as well.

And I think you have got to admit that that is going to be appallingly complicated.

Mr. McKEE. We have some staff views on this issue which are not very complicated, which we think might ameliorate some of the difficulties. But again, I think it is appropriate for a lot more staff work to be done on this issue.

Senator WALLOP. Does the Treasury dispute the fact that when a mine operator is required by both State and Federal law to reclaim lands disturbed in the process, that that liability is a reality?

Mr. McKEE. He clearly has the liability. He has no present liability to pay anything because no work has been done, so he does not have an obligation to pay the subcontractor.

He has a liability, similarly as do many other taxpayers have liabilities for future expenses that are absolutely mandated. The guy that is doing an offshore drilling rig may have an obligation 20 years from now imposed by law to do something about that rig. He does not get a deduction for those costs today.

And there are a number of places where state laws or Federal laws impose obligations on taxpayers which will not arise, will not have to be paid, until some far future point in time. If we were to permit deductions today for all of those expenses, as I have suggested we would end up finding taxpayers asking for more of those rules to be passed, because you can end up making money off the tax system.

Senator WALLOP. But you have, at least at this moment in time, a pretty complex wicket to battle on that, if we would slip across the sea for a minute, because you have a court decision which in effect verifies that very opinion in the minds of all those people. It seems like it would be better to deal with it directly, rather than to oppose it in this relatively minor thing.

I mean, this can be circumscribed, I have no doubt about that. But you are naked, man. I mean, there is nobody out there with clothes around you.

Mr. McKEE. We would much prefer to change the legislation a little bit to deny the deduction, not only for the miners but for everybody else, as a statutory matter, and that is the kind of direction we think we need to work in. We need to somehow deal with this problem and perhaps this is the time to do it.

But whenever we do it, we have got to deal with it for all similarly situated taxpayers, not just miners, and we have to come to grips with the fact that these kinds of situations where you deduct today an expense that does not occur until the future are potentially profitmaking activities. You can come out ahead.

Senator WALLOP. OK, but that is the maybe. Then it really does not so much come down to the challenge of the all-events test as it does to the panicky feeling on the part of Treasury that somebody might be getting a little ahead?

Mr. McKEE. More than a little, Senator, a lot.

Senator WALLOP. But there is nobody here suggesting that tax not be paid, that is, at the moment, at the time when the liability

occurs. But in effect what you are saying to me is that the all-events test is met, but the time value of money is not, and that is the worry.

Mr. McKEE. Well, the policy concern that drives us to focus on the issue is the time value of money, there is no question about that. We also believe in order to avoid what we view as a disastrous policy result is that the Tax Court made a mistake and that the liability that you have to have is a present liability to pay and not a liability to do something in the future.

But there is no question that you are quite correct, the Tax Court disagrees with us 180 degrees, and it is something that does require legislation, because there are going to be—as you point out, there are other similarly situated taxpayers that are not in the mining industry, that read Ohio River Collieries and with great glee. And it is pretty extensive.

And I just think we need to address the fundamental issue here, not just in the mining situation, which is a particularly appealing case for the taxpayer because the facts are so strong for the taxpayer. Many States have escrow accounts. The time period involved is oftentimes not as long as it is in other situations.

But we just need to come to grips with the fact that the tax system when you deal with the accrual method of accounting does not function very well when the time in between the incurring of the liability and the actual payment of the expense begins to stretch out in terms of a significant number of years. The system falls apart.

Senator WALLOP. But does not this whole concept of present value of deductions go well beyond what is required by the Tax Code?

Mr. McKEE. Again, it depends upon the industry. The insurance industry, no. Here, yes. One of the concerns we have is that——

Senator WALLOP. Well, that is the point where we need to be. I have been saying all along that we could tailor this to your just-delivered answer: with the insurance industry no and here yes. That is what we are trying to get at, is the circumstance that relates directly to this industry. And the bill is very narrowly drawn and could be more narrowly drawn.

But it reflects a court decision and it certainly reflects, I think, standard thinking in the industry as to the nature of the obligation as it has occurred and the ability of the industry, with their engineering models and other things, to give a pretty accurate reflection of what the dimension of that obligation is.

Mr. McKEE. Well, again, you are quite correct in your opening remarks that it would be unlikely that either one of us would go away happy. We understand, again, that in the mining industry the estimates are probably better than they are in some other industries, although there are other industries that come in who claim to be able to accurately estimate, for instance, product liability expenses on the basis of statistics. If we build a car today, so many of them are going to get in accidents and so many of them are going to cause a death, and it goes on and on and on, even though those obligations of dollar liabilities may not come to fruition for 10, 15 or 20 years.

Senator WALLOP. Well, there is never a liability until the event. They are statistical liabilities, but these are not statistical liabilities. These are actual liabilities.

Mr. MCKEE. They are also actual liabilities, and one of the classes of cases that we worry about is, as I say, statutorily imposed obligations on a taxpayer. For example, if you put a nuclear power plant in place today, you have to decommission it at some future point in time. One of the issues that has come up as well is whether you can accrue the decommissioning expense today, even though you do not pay it for 25 or 30 years?

When you run the present values on that, I guarantee you that that is a profitmaking activity.

Senator WALLOP. Well, that could be, but that is another problem, one which I do not want to quarrel with you on, except in this instance I disagree with you. And what you are really stating is a policy that we ought to abandon the accrual basis and make all taxpayers go to the cash basis.

Mr. MCKEE. We certainly should take a close look at the accrual method of accounting when there is substantial time elapsed between the time at which the expense can be accrued and when it actually has to be paid. When those time periods get to be long, the system simply becomes nonfunctional. We do not want a tax system in which taxpayers profit from incurring expenses.

Any time that the taxpayer goes out and they say, well, it is going to cost you x dollars to decommission or x dollars to reclaim the land 10 years from now, the taxpayer says: Oh, let us not make it x, let us make it $10x$, because I can figure the more it is going to cost me, if I can deduct it today, I will make a profit.

Senator WALLOP. You can quite easily contest that, and you know that. And that is a basically irrelevant concept, because as we proceed into this thing—and I have a rather quizzical thought. First of all, you ran a new industry on me when we were talking about the insurance industry, whereas I was saying that is not an actual liability but a statistical liability which may or may not occur.

Mr. MCKEE. Well, everybody dies sooner or later, I think.

Senator WALLOP. You are talking about that segment of it, but certainly not in accidents.

Mr. MCKEE. I was focusing on the life insurance industry, where you are focusing on estimates of when someone is going to die. And I think we would all agree that it is pretty much the same as mining reclamation expenses. When you are born, we know you are going to die; it is just a question of when. We know when you dig the ground you are going to have to fix it up, but it is not clear exactly what year you will fix the ground up.

Senator WALLOP. It is much more clear, because in the instance of the mining industry you have mining plans. Much deviation from that and you are in bad trouble. You will lose your permit to mine very quickly.

At any rate, we have battered this poor dog enough. We will let him lie and listen to the other side, the mining industry's viewpoints.

Mr. MCKEE. Thank you.

Turning now to S. 1006, S. 1006 would repeal two provisions enacted by TEFRA, under the Internal Revenue Code, a statutory percentage of a taxpayer's gross income from iron ore and coal property is allowed as a deduction for depletion under the percentage depletion method. It is computed without regard to the taxpayer's basis for property, and consequently, using percentage depletion, the taxpayer may deduct an amount greater than his adjusted basis in the property.

The code also contains some rules dealing with the corporate minimum tax on certain tax preferences, and one of the tax preference items is percentage depletion in excess of the adjusted basis of mineral property.

Last summer, in enacting TEFRA, Congress reviewed numerous corporate tax preferences that have been added through the years and concluded that some of these tax preferences should be scaled back.

There were three reasons expressed by Congress in doing the first. There was concern about large Federal deficits, and it was felt that if we were going to reduce spending programs, we also should reduce certain of the tax preferences.

Second, in 1981, Congress enacted certain generous, broad-based incentives for investment in plant and equipment, and it was thought that these incentives make more narrowly targeted corporate tax preferences less necessary.

Finally, there was concern that excessive use of certain preferences by particular industries might make the tax system appear less equitable. Therefore, as a response to that, Congress last summer provided for a 15-percent cutback in certain tax preferences and included among those preferences was the excess of percentage depletion otherwise allowable for iron ore and coal over the adjusted basis of the property. Because of the minimum tax adjustment, however, only 71.6 percent of the excess of the allowable depletion allowances over the adjusted basis of the property is treated as an item of tax preference under the minimum tax. The corporate tax preference reductions enacted last summer are generally effective for years beginning after December 31, 1982, but the provision relating to the cutback of the depletion applies to taxable years beginning only after December 31, 1983.

We are opposed to the enactment of S. 1006. The concerns expressed by Congress when enacting TEFRA last year have not eased. We are still facing large budget deficits. It continues to be a desirable objective of tax policy to reduce special tax benefits that apply only to particular industries and activities at times of budgetary constraints, and the reduction of special industry preferences we feel is preferable to raising Federal revenues by increasing rates generally.

The tax preference cutbacks enacted by TEFRA were designed to spread the loss of tax preferences across a wide spectrum of business activities so as to not unduly burden any one segment of the economy. Repeal of this one provision relating to iron ore and coal will invite other industries to seek repeal of the cutbacks affecting them. In other words, it is our understanding that the package that was put together in TEFRA was in fact that it was a package of various provisions dealing with numerous industries in an effort to

raise revenues. We are quite concerned that if we begin to unravel any portion of that package, that other portions of that package will begin to unravel.

For that reason, we oppose the adoption of S. 1006.

That concludes my prepared remarks.

Thank you.

[The prepared statement of William S. McKee follows:]

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For Release Upon Delivery
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May 23, 1983

STATEMENT OF
WILLIAM S. McKEE
ACTING DEPUTY ASSISTANT SECRETARY
(TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
OF THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on S. 237, which would permit both cash and accrual method taxpayers to deduct the estimated cost of surface mining reclamation work in a taxable year prior to the year such work is performed, and S. 1006, which would repeal the 15 percent corporate tax preference reduction in the percentage depletion allowance for coal and iron ore. For reasons that I will discuss, Treasury is strongly opposed to both of these bills.

S. 237
Current Deduction for Estimates of Future Reclamation Expenses of Surface Mining

Background

The Surface Mining Control and Reclamation Act of 1977 and similar state laws require surface mine operators to restore land that is damaged by the mining process. In many cases the mine operator either must post a bond to insure his

future performance of the required reclamation work or otherwise must demonstrate financial capability to perform the required reclamation work after mining activities are completed.

S. 237 is an outgrowth of a controversy which has existed for some time between mine operators and the Internal Revenue Service over the proper time to accrue deductions for the cost of statutorily mandated reclamation work to be performed in the future. The Service takes the position that such expenses are not accruable until the taxpayer incurs a present liability to pay for the reclamation work. Taxpayers argue that the estimated amount of the reclamation expenses should be deductible when the statutory obligation to perform the reclamation work arises.

In a recent decision, the Tax Court held that the estimated expenses of an accrual method taxpayer to be incurred in future taxable years to satisfy its statutory obligation to reclaim strip-mined land were accruable during the year of the mining operation, even though reclamation work had not been started and the taxpayer had no present liability to pay for the performance of such work. Ohio River Collieries Co. v. Commissioner, 77 T.C. 1369 (1981). S. 237 would codify the Tax Court's decision on this issue for accrual method taxpayers and would provide similar treatment for cash method taxpayers.

Description of S. 237

S. 237 would permit both cash method and accrual method taxpayers, in computing taxable income for any year, to elect to deduct a reasonable addition to any reserve established for the estimated expenses of surface mining land reclamation. The election would be made on a property-by-property basis. For this purpose the term "property" has the same meaning as in section 614 of the Code; that is, each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land is treated as a separate property. The estimated expenses would be allocated to the minerals extracted. Thus, the accrued reclamation expenses would be deducted over the life of the mine as minerals are produced. Alternatively, a taxpayer may elect to allocate estimated expenses to the property "disturbed" rather than to minerals extracted. This would mean that expenses could be deducted as the land is "disturbed." S. 237 does not clarify what types of "disturbance" would give rise to the deduction.

S. 237 defines the "estimated expenses of surface mining land reclamation" as those expenses otherwise deductible under the income tax law which (1) are attributable to "qualified reclamation activities" to be conducted in future years, (2) are subject to estimation with reasonable accuracy, and (3) are either allocable to minerals extracted before the end of the taxable year or are allocable to that portion of the property disturbed in the taxable year. The term "qualified reclamation activities" is defined as land reclamation activities conducted under a reclamation plan submitted as part of a surface mining permit application under the Surface Mining Control and Reclamation Act of 1977 or under a plan submitted pursuant to a Federal or State law imposing substantially similar surface mining land reclamation requirements. If the amount in any reserve for estimated expenses of surface mining land reclamation is determined to be excessive at the close of any taxable year, then the excess shall be included in gross income in that year. Nonqualified land reclamation expenses of electing taxpayers would be deductible in accordance with regulations to be prescribed by the Secretary.

The bill also provides special treatment for estimated expenses of surface mining land reclamation that are attributable to mining activities occurring before the first taxable year for which the reserve accounting method is elected and that have not previously been deducted. These estimated expenses are treated as deferred expenses and may be deducted ratably over a 60-month period beginning with the first month of the first taxable year for which reserve accounting is elected. If mining of a property with respect to which there are deferred expenses will be completed in less than 60 months, then the expenses can be deducted ratably over that shorter period.

The bill generally would be effective for taxable years ending after the date of enactment. However, it also would validate retroactively the deduction of these estimated future expenses for accrual method taxpayers who have accrued such expenses for one or more taxable years ending on or before the date of enactment.

Discussion

S. 237 deals with a problem of income measurement that is not unique to the mining industry. Taxpayers often generate income in one year and incur an expense directly associated with generating that income in a subsequent year. Indeed, generally accepted accounting principles frequently require the establishment of reserves for such future expenses, thus reducing net profit as reported on financial statements.

At first glance, there is some appeal to taxpayers' claims that they should be entitled to current deductions for these future expenses. The true profit from any income-producing activity can only be determined by taking all related expenses into account. Nevertheless, there are three broad considerations that militate against permitting current deductions for future expenses. First, a rule that grants a deduction today for tomorrow's expense overstates the true cost of the expense to the extent that the rule fails to take into account the time value of money. Second, such a rule is difficult to administer, since estimates of future expenses are inherently uncertain. Finally, the revenue loss from such a rule, applied evenhandedly to all similarly situated taxpayers, would be prohibitive.

The first of these problems -- the overstating of the true cost of the future expense -- is best demonstrated by example. Assume the taxpayer generates $100 of income in year 1 from an activity which will generate a corresponding expense of $100 six years later (year 7). If the taxpayer is permitted to accrue the $100 expense, he will report no net income from the activity. But since the taxpayer has the unfettered use of the $100 of income beginning in year 1, at the end of six years he will have substantially more than $100 with which to pay the expense. If he has been able to earn a 12 percent after-tax return on the funds during the six-year period, he will have about $200. The problem lies in the fact that the true cost in year 1 of the future outlay is the present value of the outlay amount, which in this case is about $50. Thus, the taxpayer's true profit in year 1 is $50 ($100 income less the $50 present value of the future expense), and the appropriate tax (assuming a 50 percent tax rate) is $25. Unfortunately, our present income tax system does not reach this result because it does not take into consideration the time value of money.

Conversely, delaying the taxpayer's deduction to year 7 always produces the correct result. In reality what has happened is that the taxpayer has charged $50 for the product sold and $50 to fund his future obligation seven years hence.* This latter $50 will bear a $25 tax in year 1 and the remaining $25 will grow to $50 in year 7, which will equal the taxpayer's net after-tax cost ($100 expense less $50 tax savings) of the obligation in year 7.

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*A detailed discussion of the effect of the timing of the deduction for the future obligation on the amount charged to fund that obligation is set forth in the attached appendix.

While deferring the tax deduction to the year in which the expense is incurred thus produces the correct result, the taxpayer in some cases may have insufficient income in the later year against which to offset the deduction. The net operating loss carryback provisions will not remedy the situation if the taxpayer had insufficient income in the taxable years to which the deduction can be carried back. If the taxpayer is forced to carry the loss forward, the value of the deduction will decline in present value terms. If relief is considered necessary, then the appropriate solution would be to amend the net operating loss provisions to provide for a longer carryback period in the case of losses of the type at issue here, as has already been done in the case of product liability losses under current law.

A second inequity with deferring the tax deduction may arise when the taxpayer is required to escrow funds currently to meet the future obligation but the taxpayer is not entitled to receive the benefit of a market rate of interest earned on the escrowed funds. However, if the taxpayer is denied such interest on the escrowed funds, his economic disadvantage is caused by the terms of the escrow arrangement rather than by the Federal tax law.

There is precedent in the tax law for reserve accounting methods of the type provided by S. 237. The Internal Revenue Code of 1954, as originally enacted by Congress in 1954, contained a provision, section 462, which permitted the accrual of current deductions for future expenses attributable to income generated in the current year. This provision was repealed, retroactively, in 1955. Even though section 462 was consistent with generally accepted accounting principles, the administrative problems and potential revenue losses caused by the provision were found to be intolerable shortly after enactment of the 1954 Code. It was simply impossible to impose any workable limitations on the categories or amounts of the future expenses for which reserves could be established and current deductions claimed, and the potential revenue losses from allowing all similarly situated taxpayers to create and deduct such reserves were unacceptable.

The foregoing discussion makes it clear why Treasury opposes S. 237. The mathematical examples show that the denial of current deductions for future reclamation expenses required by Federal or State statutes penalizes taxpayers only to the extent that the taxpayers are unable to obtain immediate tax benefits from the deductions in the year the expense outlays are made. This hardship, if it exists at all, is minimal compared with the unfair advantage that would

be given to mining companies by allowing current deductions for the undiscounted amount of the future outlays.

Moreover, the enactment of this bill to give special treatment to mining companies would have broad implications with respect to the deductibility of reserves for similar expenses incurred by other taxpayers. If current deductions are allowed for estimates of future reclamation expenses, it would be difficult to deny taxpayers the right to establish reserves for the estimated amount of workers' compensation costs, product liability and warranty claims, unfunded pension liabilities, costs of dismanteling offshore drilling rigs or decommissioning nuclear power plants, and the like. The past experience with the broad rule of section 462 of the 1954 Code shows that the potential revenue losses from applying this accounting method to similarily situated taxpayers would be prohibitive.

Proponents of S. 237 argue that our concerns in this area are rendered moot by the Ohio River Collieries case, and that the legislation merely codifies current law as to the appropriate time to accrue reclamation expenses. We disagree. We believe that Ohio River Collieries was incorrectly decided and that the "all events" test for accruing deductions under current law does not mandate the results provided by the two bills. Rather, we believe that current law allows a deduction for reclamation expenses only when the taxpayer has a present liability to pay for such expenses. However, if legislation is needed to eliminate the uncertainty resulting from the current conflict between the Internal Revenue Service and taxpayers on this issue, the legislation should confirm the correctness of the Service's position and eliminate the ability of mining companies to understate their incomes in the manner allowed by the Ohio River Collieries case. Indeed, we see the issue underlying that case -- the failure of our system to take into account the time value of money -- as a major problem which has ramifications beyond the specific facts of that case and we are currently studying appropriate approaches to this problem. In the interim, the Internal Revenue Service intends to continue litigating cases such as Ohio River Collieries in order to assure consistent application of the "all events" test of present law.

Finally, regardless of the argument that can be made as to the proper time for accrual method taxpayers to deduct future expenses, there can be no debate about the appropriate time for cash method taxpayers to deduct these expenses. The law has been consistently clear that a cash method taxpayer can only deduct an expense when he has actually paid it. We strongly object to the provisions in S. 237 that would permit an exception to this longstanding rule.

Conclusion

Treasury strongly opposes S. 237. The bill would permit mining companies to understate their incomes significantly by claiming current deductions for the undiscounted amount of future expense outlays. More importantly, enactment of the bill would open the way for additional legislation to permit other taxpayers to establish reserves for the estimated amount of future expenses associated with current income-producing activities. The bill should not be viewed as merely codifying existing case law in a discrete area.

S. 1006
Repeal of Corporate Tax Preference
Reduction for Iron Ore and Coal

S. 1006 would repeal two provisions enacted by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). These are the 15 percent corporate tax preference cutback of the percentage depletion deduction in excess of the adjusted basis of iron ore and coal property and the correlative adjustment to the corporate minimum tax.

Background

Under the Internal Revenue Code a statutory percentage of a taxpayer's gross income from iron ore and coal property is allowed as a deduction for depletion. The percentages are 15 percent for domestic iron ore, 14 percent for foreign iron ore and 10 percent for coal (including lignite). The deduction may not exceed 50 percent of the taxpayer's taxable income from the property. If a taxpayer claims cost depletion, the allowance for depletion may not exceed the taxpayer's adjusted basis in the property. However, percentage depletion is computed without regard to the taxpayer's basis in the property. Consequently, by using percentage depletion, a taxpayer may deduct an amount greater than his adjusted basis in the property.

Under the Code, corporations generally are subject to a minimum tax on certain tax preferences. The tax is in addition to a corporation's regular tax. The amount of the minimum tax is 15 percent of the corporation's tax preferences in excess of the greater of regular income tax paid or $10,000. One of the tax preference items is percentage depletion in excess of the adjusted basis of mineral property.

In the course of enacting TEFRA, Congress reviewed the numerous corporate tax preferences that have been added over

the years in order to stimulate certain business investments and advance other goals. It concluded that some of these tax preferences should be scaled back. The reasons given for this action were three-fold. First, there was Congressional concern over large Federal deficits. It was felt that if reductions in Federal spending programs were required to reduce these deficits, it was appropriate that some tax preferences also should be reduced. Second, in 1981 Congress enacted the Economic Recovery Tax Act, which provided generous tax incentives for investment in plant and equipment. Those incentives make more narrowly targeted corporate tax preferences less necessary. Third, there was concern that the use of tax preferences that give special advantages to particular industries makes the tax system less equitable.

For those reasons Congress provided in TEFRA for a 15 percent cutback in certain corporate tax preferences. Included among these preferences was the excess of percentage depletion otherwise allowable for iron ore and coal over the adjusted basis of the property. However, because of the minimum tax adjustment, only 71.6 percent of the excess of the allowable depletion allowances over the adjusted basis of the property is treated as an item of tax preference under the minimum tax.

The corporate tax preference reductions enacted in TEFRA generally are effective for taxable years beginning after December 31, 1982. However, the provision relating to the cutback of depletion applies to taxable years beginning after December 31, 1983.

Discussion

The Treasury Department opposes enactment of S. 1006.

The concerns expressed by Congress when enacting TEFRA last year have not eased. We are still facing large budget deficits and it continues to be a generally desirable objective of tax policy to reduce special tax benefits that apply only to particular industries and activities. The reduction of special industry preferences is more desireable than raising Federal revenues by increasing general tax rates.

At the time Congress enacted TEFRA it was recognized that the economy was still recovering from a recession. Nevertheless, it was felt that some reductions in tax preferences were justified if any headway was to be made in reducing Federal budget deficits. Today, given our

continuing budgetary concerns, it is even more important to control unnecessary reductions in tax receipts. The benefits from the economic recovery now underway should more than offset the loss of tax subsidies in the affected industries.

Finally, it should be recalled that the tax preference cutbacks enacted by TEFRA were designed to spread the loss of tax preferences across a wide spectrum of business activities so as not to burden unduly any one segment of the economy. Repeal of this one provision relating to iron ore and coal will invite other industries to seek repeal of the cutbacks affecting them, thereby undermining all of the corporate preference cutbacks enacted in TEFRA.

Adoption of S. 1006 will reduce Federal tax receipts by $52 million in fiscal 1984, $45 million in fiscal 1985, $46 million in fiscal 1986, $51 million in fiscal 1987 and $53 million in fiscal 1988.

* * *

That concludes my prepared remarks. I would be happy to respond to your questions.

Appendix

Analysis of Alternative Tax Treatments Of Deferred Expenses

I. Nature of the problem

It is frequently the case that a current exchange of goods and services entails completion of a future action by the seller. When that future action requires the expenditure of resources by the seller, the question arises as to whether those expenditures should be taken into account in determining the seller's current year pre-tax or taxable income. The correct answer to this question is a rule which ensures that the amount charged by the seller reflects no more than the resource cost of completing the transaction. The purpose of this Appendix is to demonstrate that the present law rule which requires that the seller include in his gross income for the current year the entire proceeds of his sale while deferring to the later year the deduction of the associated expense generally produces the correct result. The analysis also identifies the error implicit in an alternative rule that would permit the seller to currently deduct the future cost.

The exposition following includes: first, a description of the determination of the price to be charged absent the influence of income taxation; second, a measure of the seller's income in the year a sale is made which requires a future year expenditure; third, a demonstration that the present law rule does not affect the current year price charged; and finally, an identification of the logical error in formulation of the alternative rule under which the seller's current year taxable income is measured as the sales price less the future cost of completing the transaction. The facts of the example used in the testimony will be used to provide numerical results.

II. Determining the current year price to be charged a buyer of goods or services when the seller becomes obligated to incur a future expense.

If all a coal mining company must do to produce a ton of coal for sale is mine it and otherwise prepare it for delivery to a buyer, the price charged would have to be sufficient to cover all the expenses incurred in its production: wages of coal miners, the cost of materials consumed in mining, and a gross return to mining company capital sufficient to cover depletion of its reserves, and depreciation of its equipment and to provide a return to its creditors and equity owners. Since the price to cover all these costs of production multiplied by the quantity mined is reported by the mining company as "gross income," the company is allowed to deduct the wages paid and the cost of materials used up, since these elements of gross income are allocable to those productive agents. The coal company is similarly permitted to deduct depletion and depreciation costs to determine pre-tax income. After the mining company deducts the interest paid creditors--their share of the pre-tax income from capital employed in the mine--the

residual is the pre-tax income of equity owners. Taxation affects the cost of mining coal only to the extent it affects the cost of wages or materials or the pre-tax rates of return of creditors and equity owners. So long as costs incurred in simple mining are appropriately measured and allowed as deductions to the mining company, the income taxation of coal mining companies, per se, does not affect the price of coal.

Now suppose that, in addition to incurring these current costs of mining coal for sale, the mining company must also restore the land to some specified condition after mining is completed. Clearly, an additional cost to the mining of coal has been imposed. Since this future reclamation expense is effectively independent of the mining cost, it can be isolated in determinating its effect on the price of mined coal. Let us symbolize the cost to be charged coal buyers for this service as P_1, the subscript indicating that it is a price to be charged in year #1, when the coal is mined.

If we symbolize the future outlay to reclaim the mined land as O_n, the subscript indicating the year when the reclamation outlay will be made, then the only other determinant of P_1 is the discount rate by which the current year charge can be related to the future outlay. Let us call this discount rate, which is the opportunity cost of shifting payment obligations over time, r. Then, ignoring taxation,

$$P_1 = O_n (1+r)^{-(n-1)}. \qquad (1)$$

That is, referring to the example in the testimony, where O_n = \$100, n=7 and r= 0.12, P_1 = $\$100(1.12)^{-6}$ = \$50.66. The seller would have to charge the buyer at least \$50.66 in year #1 so that, 6 years later, he would have accumulated \$100 with which to cover the costs of reclamation (in year #7). From the buyer's point of view, he would pay no more than \$50.66 in year #1 for he could take that capital sum and accumulate it over 6 years to \$100 and, himself, requite the reclamation cost of \$100.

III. The seller's income.

Suppose that the cost assumptions of the above example hold. What is the measure of the coal miner's income in year #1 when he receives the \$50.66? Obviously, with respect to the \$50.66 received for the sale of coal, it is zero; He has simultaneously received a market payment of \$50.66 but incurred an obligation to cover a future expense the present value of which is exactly equal to \$50.66. Therefore, for financial statement purposes, the receipt of the \$50.66 has no effect on the company's income statement; but it will have a balance sheet effect. On the balance sheet, the \$50.66 will be an increase in assets (earning 12 percent, by assumption) offset by the recognition that there is a future \$100 obligation, less a "discount" of \$49.34, which represents the 6-year cumulation of earnings of the \$50.66. With each passing year, the mining company will record interest income and a corresponding decline in the "discount" associated with the year #7 reclamation obligation. If it does not in fact accumulate among its assets the interest earned, when the \$100 outlay is made the mining company will suffer a \$49.34 decline in net worth.

IV. Introducing income taxation.

In order to simplify exposition, we shall now assume the r in equation (1) represents an after-tax rate of return to capital employed in the enterprise. There are two income tax formulations for the treatment of P_1 that will give the same result as equation (1): The present law rule, and another rule which applies the result in III, above, namely, that there is zero pre-tax income in year #1.

First, we rewrite equation (1) to introduce an income tax levied at rate m. If T_1 = tax due in period #1 and T_n the tax due in period n,

$$P_1 - T_1 = (O_n + T_n)(1+r)^{-(n-1)} \qquad (2)$$

Symbolically, equation (2) simply says that P_1, less tax due when it is received, must be equal to the future outlay, plus tax due, when the outlay is made in year n, all discounted to the present.

Under present law, which taxes P_1 as received and allows a deduction of O_n in year n,

$$T_1 = mP_1 \qquad (3a)$$

$$T_n = -mO_n. \qquad (4a)$$

If equations (3a) and (4a) are substituted in equation (2), the result is:

$$P_1(1-m)=O_n(1-m)(1+r)^{-(n-1)},$$

which, of course, is exactly the same as equation (1) after cancelling the (1-m). Applying the present law rule to the factual assumptions in the testimony example produces a P_1 = $50.66, and if we take m = 0.40, $20.26 will be paid in tax (T_1=$50.66 x 0.40) leaving the miner a capital fund of $30.40

which will accumulate to $60 in year #7, at which time the miner will receive a refund of $40 ($T_7$ = -$100 x 0.40) enabling him to cover the $100 year #7 cost.

Of course, if the taxpayer is allowed a $50.66 deduction in year #1 against his P_1 = $50.66 to signify his lack of economic income in that year and is not allowed to take a deduction when the expense is incurred in year #7, T_7=0, the same result is achieved as under present law, and neither rule causes an alteration in the charge for reclamation. But note that, in order to apply the latter rule, the <u>present value</u> of the future cost must be determined, and this requires estimation of a discount rate. In contrast, the present law rule which taxes P_1 and refunds with respect to O_n operates only with actual transactional data and requires no discounting.

V. The effect of erroneously permitting the current deductibility of future (undiscounted) costs.

Suppose we define P_1' to be the year #1 charge for future costs to be incurred by the seller under a tax rule that will permit the amount of the future outlay, O_n, to be currently deducted. Then,

$$T_1 = m(P_1 - O_n) \quad (3b)$$
$$T_n = O, \quad (4b)$$

and substituting these in euqation (2) and simplifying, we obtain

$$P_1 = O_n[(1+r)^{-(n-1)} - m]/(1-m). \quad (4)$$

In contrast with P_1 as determined under present law rules for P_1 and O_n, this rule makes P_1' a function of the tax rate m. In general, for all tax rates greater than zero $P_1' < P_1$, the difference being a tax subsidy to benefit the cause of the deferred expense; it results from the deduction of an undiscounted amount O_n, in year #1, and the subsidy increases with the taxpayer's marginal rate.

For example, continuing to use the testimony example in which $50.66 is the true charge for reclamation a buyer of coal should pay, allowing current expensing of $100 would result in the following:

	P_1' Buyer's reclamation charge	Subsidy ($50.66-$P_1'$)
Miner's tax rate:		
0.20	$38.33	$12.33
0.40	17.77	32.89
0.46	8.64	42.02

Of course, if competition does not drive down the reclamation charge to miners' customers, the subsidies will be converted into increased monopoly profits of miners. If for example, a monopolistic corporate miner keeps the charge at $50.66, this will increase its after-tax monopoly profit by $22.69 (=the "refund" on $50.66 of current income, less $100, times 0.46), equivalent to a taxable subsidy to him of $42.02, as shown above.

Senator WALLOP. I think you people in the Treasury Department have constant dreams of camels' noses and tent flaps in every instance.

Mr. MCKEE. Yes, we do. That is because it happens all the time to us.

Senator WALLOP. Well, I understand that.

Mr. MCKEE. We have seen a lot of camels, Senator.

Senator WALLOP. It is probably a legitimate nightmare. It is one you have to sleep with and not me. But I guess the real reflection here is that nothing much has changed since a year ago in those two industries, which was the principal reason why the Congress accepted that as a concept when we voted those in. The iron ore industry and American metals industry are certainly in a crisis situation with regards to overseas competition and the development of some kind of a situation which provides a little employment outlook, a little economic outlook.

My own feeling is that the amount of money the Treasury might be losing in this instance would be well picked up by other obligations for revenues that would occur down the road, and incidentally, I forgot to tell you what the quizzical thing was, but if these people are making all of that profit on investing their time value deductions, are you not going to tax that?

Mr. MCKEE. That is the difficulty. The profit that people make on the time value of money through the tax system is purely done by manipulating the tax system. It is very hard for us to capture those revenues when you are basically working the tax system itself for your profit.

Senator WALLOP. It seems like if you have made a profit at one time or another, that money is going to show up in some type of an effect.

Mr. MCKEE. Well, that is certainly true. You not only get your profit from the time value of money as an after-tax profit. The simplest way to see it is in our coal mining case. When he deducts the $100 today and saves $50 in taxes, it is assumed he puts his $50 in tax-exempt bonds.

Senator WALLOP. It does not really matter where he puts it. It goes into the system and gets taxed.

Mr. MCKEE. Well, in the tax-exempt system, it does not get taxed but the need to focus is that it gets it after.

Senator WALLOP. You can make a rule that no one can invest their ill-gotten gains from the time value of money deductions in tax-exempt bonds——

Mr. MCKEE. Senator, the important thing to see is that I think you and I would both agree that if your tax lawyer came to you and said look, Senator, I will give you a deduction of $100 today, but you do not have to pay any money for that, and that will save you $50 on your tax returns, and you will get a check from the Government for $50, and sometime 20 or 30 years from now you are going to have to pay that $100, but you do not have to worry about it until 20 or 30 years from now, I guarantee you you will tell your tax lawyer to get as many of those deals as you can get because you know you can take the $50 refund check that you get from Uncle Sam, which is taxes that somebody else has to pay to

make the system go, and you can invest it and make a profit, and 20 years later you will gladly pay the $100.

We see that as the whole foundation of the tax shelter industry.

Senator WALLOP. Do not say you in that because if I get a check for $50, I would just give it to you for the rest of my taxes.

[General laughter.]

Senator WALLOP. That piper gets paid. I found that out.

Senator Heinz, do you have anything?

Senator HEINZ. Senator Wallop, first of all, just let me commend you for holding these hearings on two bills that are important to my State and I think to the country, S. 237, your bill, and S. 1006, Senator Specter's bill.

I think I came in at an interesting point in the discussion between you and Mr. McKee, and I suspect you have already been over the plowed ground, or should I say, the ground that is to be reclaimed here, in some considerable detail.

But I was wondering if Mr. McKee had been posed and answered the question how in the face of the decisions by the third and fourth circuit courts of appeals and the Tax Court, which have ruled in favor, I gather, of the coal producer on the issue that S. 237 addresses, how the IRS justifies its particular position other than they do not agree with the courts?

Mr. MCKEE. Well, Senator, as I discussed with the chairman, what we would hope is that you would see fit to, if you think legislation is appropriate, we would like for you to legislate in favor of the IRS position, and then we will not have to worry about it anymore. We will have a nice statute that tell us that you cannot deduct these, and we will not have the controversy.

Senator HEINZ. Can I take from that statement that you are not about willing to bow to the court interpretations of the law?

Mr. MCKEE. We are certainly continuing to disagree with the courts on the technical issue involved, which the technical legal issue involved as to whether or not you must merely incur the liability or whether you must have an actual liability to pay the expense. We are particularly distressed with, and it is unfortunate. It is our own fault. The Government conceded in Ohio River collieries one of the key facts in the case, which is that the expenses could be reasonably estimated.

As you know, the litigation in this area, the cases, as often as not, turn on the factual issue of whether or not the expense can be reasonably estimated. There are two issues here. The Government would like to reserve its ability to continue to puzzle over both of those issues. There is no question that in the mining and reclamation area, that the litigating record of the Government has been poor. We are not as yet ready to concede a decision as to whether or not to continue to litigate these cases has not been made yet.

We would, as I discussed with the chairman, we think that the whole issue of accruing expenses today which are not going to be paid for a long period in the future is one which the Congress needs to look at, and they need to look at it fairly quickly. We know you are going to look at it in the insurance area, but that is—the insurance area is merely one place where this problem occurs, and it occurs here, and it occurs in many other places.

And to repeat, the tax system is always in trouble, whenever the taxpayer, when he is faced with an expense, wants the expense to be bigger because he knows that the bigger the expense, the better tax deal he is going to get, and any time you are in a situation where the expense is going to be put off for a large number of years but you can deduct it today, you would always like the expense to be bigger because the tax deduction is bigger, and the tax savings today will more than pay for the expense in the future, and leave you with a profit.

That is what a lot of tax shelters are all about. We see them in a number of places in the system. The difficulty with miners' case is that it quite frankly is an appealing set of facts. I mean, it is a tough industry, and you are not dealing with manufactured expenses. The taxpayer has an excellent set of facts to make the case. But the economics are still there. The miner, if the time between the incurring of the expense and the payment is long enough, is perfectly—if you let him deduct it today, he does not care about the expense because the expense is funded totally out of the tax system. There is no economic cost to the miner if that time period is long enough.

Now, admittedly, in most cases, most cases dealing with mining, that time period is not that long, but I dare say that if S. 237 is passed, we will find some mining rules that are kind of strange if the tax shelter industry gets ahold of it.

Senator HEINZ. I am tempted to ask, but I am not going to, how you think this treatment compares to the revised treatment of the completed contract method of accounting that was part of TEFRA last year, where we still permit the deferral, in effect, of taxes for an extended period of time, maybe not forever as we did under the old completed contract method of accounting.

I have not heard you litigating the completed contract method of accounting lately.

Mr. MCKEE. Senator, I think you have raised a very good point, and I think all of these timing issues in the accounting area need to be looked at. Congress looked at the completed contract method and came up with some—they addressed the issue and they came up with some time periods involved in which they were going to say that if the completed contract involved contracts of more than a certain period of time, tougher rules would come into play. It may be that that is the approach that needs to be taken here. As I discussed with the chairman, or as he asked me, I volunteered the Treasury would be more than happy, we would be delighted to work with the committee to attempt to fashion appropriate rules not only dealing in the mining area but in other areas to try to bring these deferral issues to light and to get a fairly uniform treatment across the economy.

As I mentioned before, and I would mention again, the insurance industry is one in which the problems are most severe, and they are being addressed, and we have testified on that, and this is simply another feature of that same problem.

Senator HEINZ. Both S. 237 and S. 1006, for different reasons, aim at the same goal, which is the prevention of the increase of taxes, in this case, on an industry, the coal industry, and in the case of the second bill, iron ore as well as coal. The President has

told us that we should not raise taxes when an economic recovery is about to or is taking place. These two industries, coal and steel, are, at least in the case of steel, in the incipient stage of economic recovery, and in the case of coal, there is some question as to whether an economic recovery has even begun. There are more people laid off in the coalfields today than there were a year ago. Capacity utilization or capacity operation in the coal industry is even lower.

What argument can you make in favor of raising taxes on two hard-pressed industries, and why do you do it to these two industries which are among the most hard pressed? Why is that not just grossly unfair?

Mr. McKee. Senator, turning to S. 1006, which raises the issue quite directly, Congress last summer put together a package attempting to raise revenue, put together a package of provisions designed to deal with the more narrowly targeted tax rules in the code, tax preferences, because they felt that the broad-based tax incentives that were put in the code in 1981 were fairly generous and they decided that it was time to tighten up a little bit on some of the more narrowly targeted provisions.

As you know, at one point in the process of the last summer's tax act, coal and iron ore were going to be subject not only to the cutback provision, but were also 15 percent of the capital gain under section 631(c), was going to be treated as ordinary income.

There were then a lot of negotiations back and forth. Senator Symms was involved with them on behalf of some of the minerals, and the compromise that was reached in an effort to design a package which met with the overall relative positions of the industries involved, the package was that the 15-percent conversion from capital gain to ordinary income for coal and iron ore was dropped. The coal and iron ore was still subject to the cutback, and other minerals were relieved. And apparently Congress and this committee felt that that was an appropriate way to spread the burden across all of the industries.

Senator Heinz. I was a member of this committee at the time.

Mr. McKee. I know that, Senator.

Senator Heinz. I am not unfamiliar with the background. That does not really answer my question, though, especially since it is only coal and iron ore that, as you pointed out in what you just said, are subject to this elimination and depletion at the end of 1984. I mean, why is this good economic policy, and why does it, or how, if at all—I do not think it does—does it meet the test of fairness?

Mr. McKee. Well, I can only say that as the Congress put together the package last summer and attempting to balance all of the competing interests and all of the industries involved, this is the package that was worked out, and Treasury simply feels that if one portion of that package is unraveled, other portions of that package will be unraveled. At a time when we are faced with severe budget deficits, we think that it is appropriate to leave the package as it was put together by the committee, and I think that is the only answer we can give you, Senator, is that we see the law as we see it, and we understand how it got to where it is. It was agreed upon by all of the competing interests, and we are very concerned that

pulling one part of the package out is going to lead to an unraveling of the rest of the package.

Senator HEINZ. Maybe the package was flawed. Maybe we ought to make a change.

Mr. MCKEE. Well, that is, again, the Treasury is of the view that the package——

Senator HEINZ. Apparently 10 percent withholding was not crafted quite right, and the President apparently is going to agree that we did not craft 10 percent withholding quite right, as I understand it.

Mr. MCKEE. I think you can appreciate I have no comment. [General laughter.]

Senator HEINZ. Well, what is sauce for the goose is sauce for the gander.

Mr. Chairman, thank you.

Senator WALLOP. I thank you, Bill, very much. I will call the Honorable Don Bailey up, and while you are coming, Don, if you would not mind the indulgence. Senator Symms has a statement to make while you are making up.

Senator SYMMS. Thank you, Mr. Chairman, and Bill, I hope you have not completely left the room before I finish my statement because I did not want to take up the time of the chairman here to ask any more questions, and I thought that the two Senators had adequately, and your statement, covered the administration's position, but I do want to thank you, Senator Wallop, for holding the hearing, and I am particularly grateful for your continuing interest in pursuing the Comprehensive Mining Reclamation Reserve Act, and that would solve—that is S. 237, which would solve the long-running dispute between the mining industry and the IRS because when the IRS issued a revenue ruling in 1978 which sought to reverse the manner in which the operators had been accounting for their reclamation expenses.

Hopefully the committee will act quickly on this legislation, and it always seems nonsensical to me that our Government continues to make it difficult for the producers of the economy to function. This committee is continually having to correct the activities of the IRS through legislation when the Service has absolutely no justification for trying to legislate through regulation. It seems to me that the Government should start to harass the nonproducers in our economy who are illegally accepting benefits from the public dole for which they are not eligible.

And with regard to S. 1006, the legislation offered by Senator Specter, I am pleased to lend my support to his efforts. It was regrettable that during the consideration of TEFRA it was not possible to exclude all hard rock minerals, including iron ore and coal, from the minimum corporate tax percentage depletion preference item. However, because of the revenue involved, it was not possible to exclude coal and iron ore along with all of the other hard rock minerals.

I am hopeful that this matter can be favorably resolved in the future and that all hard rock minerals receive the same capital gains treatment as well.

I might just say, Mr. Chairman, that when one looks at the problem we have with respect to the Federal deficit, I think we might

as well have included all minerals instead of just—and not exluded coal and iron ore, because I do not think it would have made a nickel's worth of difference on the deficit that we are facing now. Yet at the time, that seemed to be a good reason, or at least the committee's judgment was that it was.

And I thank you again for holding the hearings. And Don, I will be here for part of your testimony. But when you see me leave, it is not because of my lack of friendship and admiration for you, but I have another meeting I am supposed to be at.

But thank you, Mr. Chairman.

Senator WALLOP. Could I also call Peter Lasusa up from Arthur Andersen, as well?

Welcome back here, Don. It seems like we have seen each other once before.

STATEMENT OF HON. DON BAILEY, FORMER MEMBER OF CONGRESS, GREENSBURG, PA.

Mr. BAILEY. Senator, I want to express my appreciation to you personally, and to the staff, and Senator Symms. I have been sandwiched in here, and I will take a very brief amount of time, a very brief period of time.

I have been studying, of course, this issue, since I originally introduced my bill last session, and would just like to address a couple of issues that I think you folks are extremely familiar with, and there is not that much reason to accentuate them except that they are very much a part of the IRS arguments.

One of them is the issue of estimation and the definitions surrounding when liabilities are incurred. In the interaction between you and the IRS, you really put your finger on it quite well. However, IRS is arguing, and I think incorrectly, on the estimation issue, they are using a lot of examples which are very poor. It is important to note that in the Ohio case, the collieries case, there was a stipulation, IRS stipulated as to the estimation on costs. It is a very important point.

When examples are used, for example, in decommissioning a nuclear powerplant, they are totally inappropriate. There is a dearth of information in that area. What little we do have, we have some from France. We do not really know for sure what we are talking about.

Second, the idea of deferred tax payments which IRS is trying to use as an argument against your bill is also very, very poorly used. I am sure IRS, for example, would not as a matter of policy come in and tell us that individual retirement accounts are bad ideas. Now, that is absurd. So as a matter of tax policy in and of itself, equities aside, it is very important to note that we have a number of outstanding—our Tax Code is replete with examples of policy choices that are meant to achieve certain ends and results. From a tax policy point of view, we are really talking about a cashflow issue.

And it goes back to what Senator Symms said, and that cashflow issue is simply who is going to have utilization of that money.

And I think we have always argued that in terms of our faith and support for free enterprise, it should go to the taxpayer, and

we are particularly talking about a capital intensive industry which is not treated well under the American Tax Code. We do the worst job of any major industrial nation on this Earth of understanding the needs and requirements of capital-intensive, long-term investment requirement types of industries. Every single one of them has a problem, and this bill addresses exactly what some of those needs are particularly in mining.

I think that we are talking about something else that goes back to an issue that you have raised, Mr. Chairman, and other Senators have also, and that is one of justice, what basically is fair. We all know the history of this thing. We know the IRS practice prior to the 1978 letter, that private letter. We know that for that accrual basis taxpayer, that there are arguments on when that recovery can take place, what that deduction can take place, is really unfair.

I will be working very, very hard on the House side, incidentally, to help you over there. And I would also like to say, and I do not know exactly what is going to be introduced there, but that your—I do not know. I guess it is the "as disturbed" or whatever rule has been the term that has come up on this thing—is preferably the way to go.

So I would like to commit myself to doing everything that I can to help you.

And I thank you very much. And I thank you for being so kind to me. I was rather late with the request, and you have been very kind in the past, and I have enjoyed working with you and trying to work at least over on that side.

Senator WALLOP. Well, thank you very much, and we certainly welcome you back here.

We will hear Mr. Lasusa now.

STATEMENT OF PETER LASUSA, PARTNER, ARTHUR ANDERSEN & CO.

Mr. LASUSA. Good afternoon. My name is Peter Lasusa. I am a partner in the accounting firm of Arthur Anderson & Co.

I am appearing today on behalf of Bear Creek Uranium Co., located in Wyoming. While we are representing Bear Creek, I feel the views set forth are applicable to the entire mining industry.

Thank you for giving me this opportunity to speak again before this committee on what continues to be an issue of great importance to our Nation's mining industry.

S. 237 is identical to S. 2642, which I supported when I testified before this subcommittee last year. I support the enactment of S. 237 because it is in accordance with generally accepted accounting principles and correctly reflects the current case law and Treasury regulations. Furthermore, by permitting taxpayers to deduct the cost of reclamation on an as-disturbed basis, S. 237 will have a beneficial impact on the mining industry's cash flow, an industry which is currently in a depressed economic state.

I will focus my comments on certain objections raised by Treasury in its testimony last year on S. 2642. Treasury argued that taxpayers using the accrual method of accounting for Federal income tax purposes should be denied any deduction for cost of surface

mining reclamation obligations prior to the year in which the reclamation work is performed.

By taking this position, Treasury effectively repeals the accrual method of accounting for reclamation costs. Several economic arguments were advanced by Treasury. However, at least three of these arguments, of which I will discuss two, seem flawed, which casts doubt on their overall analysis of the effects of the proposed legislation.

Treasury implies that the correct way to time the reclamation deduction, by emphasizing the taking of the deduction in the year the expense is actually incurred, insures that the present value of the deduction is equal to the present value of the expenditure. However, the equality of these two present values by no means insures the correct tax policy. In practice, tax policy reflects a number of objectives, and mechanical adherence to one narrow criteria by no means insures the correct outcome.

Treasury argues that the present revenue difference associated with deducting the reclamation expense as soon as the taxpayer is obligated to reclaim land that has been disturbed, rather than later when the reclamation work is performed, is substantial. However, the calculations on which Treasury's arguments are based, that is, 12 percent aftertax cost of money, is an excessively high interest rate, seriously exaggerating the gap between the two-cost recovery methods.

Treasury's present value argument contains a mortal flaw in that the time for the deducting of an expense and the including of revenue in income for Federal income tax purposes has never been determined to be the actual point in time when the present value of the deduction or item of income equals the funds paid or received. Treasury in its prior testimony before this subcommittee even stated, "Our present income tax system does not reach this result, because it does not take into consideration the time value of money."

Treasury cited the repeal of section 462 as an example of Congress desire not to allow the deduction of estimated liabilities for future expenses. S. 237 concerns itself only with fixed liabilities.

The following examples of current law illustrate the inconsistency of Treasury's position. Today a corporation can issue a bond for cash which is less than the face amount of the bond at maturity, so-called discount bonds. By Treasury's own regs which recently have been codified, such corporate issuer is entitled to claim each year a portion of the difference between the cash received and the face amount of the bond as a deduction for Federal income tax purposes. Here is a situation specifically sanctioned by Treasury that allows the taxpayer a deduction for an expense that will not actually be funded by the taxpayer until the bonds retire or mature, usually a very substantial time period. In this case, the present value of the deduction will be greater than the present value of the funds expended to satisfy the expense.

On the other side of the coin, take an acquisition of a fixed asset, the cost of which is deductible for tax purposes only over a number of years. In this situation, the taxpayer pays current dollars for the piece of equipment, but is entitled to a deduction related to his expenditure only over several years.

The present value of the funds expended in this example is clearly greater than the present value of the depreciation deductions. Would Treasury support the correction of this present value imbalance using the same argument they conjure up to contest the legislation being considered by this subcommittee?

Further, if Treasury were to limit deductions on a present value basis, would they also extend this concept to limit income recognition, for example, on accounts receivable?

At the time Congress has mandated a simplification of the tax law, the introduction of present value concepts to adjust the monetary value of income and deductions would add a complexity to the tax the likes of which has never been seen. For example, one of the serious questions is the determination of the appropriate discount rate. Although large companies with sizeable accounting and tax staffs or the financial resources to hire the larger accounting firms such as mine might be able to cope with this complexity, companies without these resources could not.

Thank you.

[The prepared statement of Mr. Lasusa follows:]

ARTHUR ANDERSEN & CO.

1345 AVENUE OF THE AMERICAS
NEW YORK, N.Y. 10105

UNITED STATES SENATE
Committee on Finance
Subcommittee on Energy and Agricultural Taxation

Hearings on May 23, 1983 on:

Comprehensive Mining Reclamation Reserve
Act of 1983 (S. 237)
and
S.1006

Summary of Testimony by:

Peter R. Lasusa, Partner
Arthur Andersen & Co.

Summary of Principal Points

Introduction

I am a partner in the accounting firm of Arthur Andersen & Co. While I am representing Bear Creek Uranium Company, I believe the positions set forth are applicable to the entire mining industry.

S.237

My comments are limited to S.237 which is substantially identical to former proposed legislation S.2642 on which I testified before this subcommittee on December 7, 1982. Like S.2642, S.237 provides an approach that is soundly based upon Treasury Regulations and court cases.

Accounting and Tax Conclusion

The present position taken by the Treasury is not consistent with its own regulations and case law. It is also inconsistent with the fundamental accounting principle that a liability should be recorded when known i.e., when the land is disturbed and when the costs of reclamation can be fixed in an amount with reasonable accuracy. Enactment of S.237 would codify existing case law.

Treasury Objections

Treasury has raised several objections to the enactment of S.2642. For purposes of my testimony, I have assumed that Treasury's objections to S.237 will be similar to those raised with respect to S.2642 since the bills are identical. First, they argue that no deduction should be allowed until the reclamation work is performed so that the present value of the deduction will equal the present value of the funds expended for the reclamation work. This "equality of present values" theory is directly contrary to the fundamental concepts of accrual basis accounting and therefore, has no relevance to the present tax law. Second, the Treasury's estimate of the loss of tax revenues that would result from allowing deductions for reclamation costs under the principles of S.237 is grossly overstated because their present value calculations reflect unrealistic interest rate assumptions. Finally, certain indirect effects of this legislation on tax revenues were ignored in the Treasury's calculations.

Conclusion

The weight of present judicial authority on this issue, as well as Treasury's own regulations, clearly support the result achieved by S.237.

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TESTIMONY BY PETER R. LASUSA

ON

S. 237

INTRODUCTION

Good afternoon. My name is Peter R. Lasusa. I am a partner in the accounting firm of Arthur Andersen & Co. I am appearing today on behalf of Bear Creek Uranium Company. While we are representing Bear Creek Uranium Company, I feel the views set forth below are applicable to the entire mining industry. Arthur Andersen & Co. has had significant financial and tax accounting experience in the mining industry. Our clients include many of the Nation's major mining companies. During the past several years, I have been the firm-wide industry head for mining, which involves consultation with other professionals on mining industry questions, as well as serving as an expert witness in arbitration matters relating to mining. Thank you for giving me this opportunity to speak again before this Subcommittee on what continues to be an issue of great importance to our nation's mining industry. I say 'again' because on December 7, 1982, I testified before this Subcommittee with respect to the tax and accounting status of mine reclamation expenditures in relationship to two pieces of legislation which dealt with the tax treatment of such expenditures, namely, the Mining Reclamation Reserve Act of 1981 (S. 1911) and the Comprehensive Mining Reclamation Reserve Act of 1982 (S. 2642). Essentially, S. 1911 and S. 2642 would have permitted taxpayers to elect to deduct, in arriving at taxable income, reasonable additions to reserves established for accrued expenses of surface mining land reclamation. The Comprehensive Mining Reclamation Reserve Act of 1983 (S.237), under consideration by this Subcommittee, is identical to S. 2642.

I support the enactment of S.237 because it is in accordance with generally accepted accounting principles and correctly reflects the current case law and Treasury's regulations. Furthermore, by permitting taxpayers to deduct the costs of reclamation on an "as disturbed" basis, S.237 will have a beneficial impact on the mining industry's cash flow, an industry which is currently in a depressed economic state.

Rather than repeat my prior testimony (a copy of which is attached at Exhibit I and included herein by reference) which is equally applicable to S.237, I will focus my comments on certain objections raised by the Treasury Department to legislation which would have enabled a producer to claim a deduction for reclamation costs when the producer becomes legally obligated to reclaim the land. For purposes of my testimony, I have assumed that Treasury's objections to S.237 will be similar to those raised with respect to S.2642.

On December 7, 1982, The Honorable John E. Chapoton, Assistant Secretary (Tax Policy) for the Department of the Treasury, testified before this Subcommittee in opposition to S. 1911 and S. 2642. A copy of Treasury's previous testimony is attached at Exhibit II. The Treasury Department argues that taxpayers, using the accrual method of accounting for Federal income tax purposes, should be categorically denied any deduction for costs of surface mining reclamation obligations prior to the year in which the reclamation work is performed. By taking this position, Treasury effectively vitiates the accrual method of accounting for reclamation costs.

Several economic arguments were advanced by Treasury, however; at least three of these arguments seem flawed which, in my view, casts doubt on their overall analysis of the effects of the proposed legislation.

1. Treasury implies that there is a "correct" way to time the reclamation deduction, by emphasizing that taking the deduction in the year the expense is actually incurred insures that the present value of the deduction is equal to the present value of the expenditure. However, the equality of these two present values by no means insures "correct" tax policy. In practice, tax policy reflects a number of objectives, and mechanical adherence to one narrow criteria by no means insures the "correct" outcome.

2. Treasury argues that the revenue difference, i.e. the present value difference, associated with deducting the reclamation expenses as soon as the taxpayer is obligated to reclaim land that has been disturbed rather than later, when the reclamation work is performed, is substantial. However, the calculations on which Treasury's arguments are based, (i.e., 12% after tax cost of money) use an excessively high interest rate, seriously exaggerating the gap between the two cost recovery methods.

3. Treasury's statement seems to ignore an indirect revenue effect resulting from the timing of the deduction. Allowing the reclamation expense deduction only in the year the reclamation work is performed will tend to raise product prices and lower output, relative to the situation where the expense can be deducted in the year the producer becomes obligated to reclaim the disturbed land. Lower output levels could offset, to some extent, the increase in revenues Treasury hopes to gain by postponing the deduction for reclamation costs.

1. THE "CORRECT" SOLUTION

Treasury, in its testimony on S.2642, has adopted a narrow and self-serving view when it attempts to illustrate that allowing a producer to deduct reclamation costs when the land is disturbed would provide "too much" tax relief and further that the "correct" answer would place the deduction in the final year of the project. Again, I emphasize that the so-called "correct" result would repeal the accrual method of accounting for reclamation costs.

In fact, Treasury is correct only in arguing that allowing the deduction in the year that it is paid will result in a situation where the present value of the deduction is equal to the present value of the funds used to satisfy the legal obligation for reclamation. This logic, however, contains a mortal flaw in that the time for the deducting of an expense and the including of revenue in income, for Federal income tax purposes, has never been determined to be the actual point in time when the present value of the deduction or item of income equals the funds paid or received.

It is interesting to note that at the time Treasury promulgated their regulations defining when an expense becomes an allowable deduction for Federal income tax purposes, the Court of Appeals had already recognized the validity of deducting reclamation costs prior to the time when the work was performed. If Treasury were in serious disagreement with the Court's conclusion, they could have overriden this conclusion or dealt with the present value approach in their regulations, but chose not to do so. Treasury in their prior testimony before this Subcommittee even stated ". . . our present income tax system does not reach this result because it does not take into consideration the time value of money." Thus, when Treasury argues that allowing a deduction for reclamation costs when the legal obligation to reclaim arises would leave the present value of the deduction greater than the present value of the expense, they are correct only from a purely mathematical point of view; however, such axiom has no relevance to the Internal Revenue Code as it exists today.

Accrual basis accounting is premised on the fact that income is not necessarily reportable nor expenses necessarily deductible when the funds related to the income or expense are received or paid. Treasury Regulation Section 1.446-1(c), which prescribes permissible methods of accounting for Federal income tax purposes, specifically subsection (1)(ii), states that "Generally, under an accrual method, income is to be included for the taxable year when all events have occurred which will fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy." The regulations go on to require that the method used by the taxpayer be in accord with generally accepted accounting principles applied on a consistent basis. The Financial Accounting Standards Board, in its Statement of Financial Accounting Concepts No. 3., issued in December of 1980, on page 39, paragraph 79 states that "Accrual accounting attempts to record the financial effects on an enterprise of transactions and other events and circumstances that have cash consequences for the enterprise in the periods in which those transactions, events, and circumstances occur rather than only in the periods in which cash is received or paid by the enterprise." Thus, there can be no question that the present value equation espoused by the Treasury, to support its views in opposition to the proposed legislation, is not relevant to the issues.

Treasury, in their testimony on S.2642, cites Section 462, which was later repealed, as an example of a Congressional attempt to allow the accrual of estimated liabilities for future expenses attributable to income generated in the current year. Section 462 would have permitted the deduction of contingent liabilities and so was repealed shortly after it was enacted. However, S.237 concerns itself only with fixed liabilities. Further, Treasury fails to point out that the tax law today provides many examples of situations where under the accrual method of accounting deductions are allowed where the

time lag between the deduction of the liability for tax purposes and the actual payment of the expense can be significant. Two examples will serve to emphasize the point.

Treasury has accepted this concept in the situation where a corporation issues a bond for a cash amount which is less than the face amount of the bond at maturity (i.e. discount bond). By Treasury's own regulations, which recently have been codified, such corporate issuer is entitled to claim, each year, a portion of the difference between the cash received and the face amount of the bond as a deduction for Federal income tax purposes. Here is a situation, specifically sanctioned by the Treasury, that allows a taxpayer a deduction for an expense that will not be actually funded by the taxpayer until the bonds are retired or mature, usually a substantial time period. In this case the present value of the deduction will be greater than the present value of the funds expended to satisfy the expense.

On the other side of the coin take an acquisition of a fixed asset, the cost of which is deductible for tax purposes only over a number of years. In this situation, the taxpayer pays current dollars for the piece of equipment but is entitled to a deduction related to his expenditure only over several years. The present value of the funds expended in this example is clearly greater than the present value of the depreciation deductions. Would Treasury support the correction of this present value imbalance using the same argument they conjure up to contest the legislation being considered by this subcommittee? Furthermore, if Treasury were to limit deductions on a present value basis, would they also extend this concept to limit income recognition e.g. accounts receivable?

Moreover, at a time when Congress has mandated a simplification of the tax laws, the introduction of present value concepts to adjust the monetary value of income and deductions would add a complexity to the tax laws the likes of which has never been seen before e.g. the determination of the appropriate discount rate. Although large companies with sizable accounting and tax staffs or the financial resources to hire firms such as mine might be able to cope with this complexity, companies without these resources could not.

2. TREASURY'S EXAMPLE CALCULATIONS ARE MISLEADING

The Treasury testimony on S.2642 runs through a series of calculations that purportedly illustrate the impact of claiming the reclamation expense deduction in the year the legal obligation to reclaim arises, rather than in the year the reclamation work is actually performed. However, Treasury's calculations seriously exaggerate the difference in tax revenues between the two deduction methods.

Before examining Treasury's calculations directly, it is useful to consider why the difference in the timing of the deduction matters from the Treasury's viewpoint. If, for purposes of illustration, inflation and cost of money are ignored, then the dollar value of the deduction, and resulting loss in tax revenue to Treasury, would be identical under the two scenarios.

However, it is important to realize that the timing difference may be quite significant to Treasury even though the cash flows may be the same. Treasury will correctly view revenues received in later years as less valuable than revenues received in earlier years. This is true because revenues received in earlier years can be used to reduce Treasury's borrowing costs required to fund deficits in the years between the obligation of the reclamation expenditure and the performance of the work.

Treasury indicates in their testimony on S.2642 that they would quantify the difference in the value of payments received in different time periods by determining the present value of both payments. The payments are compared by determining how many dollars Treasury would trade today for the right to cash flow at a future date. The present value of a future payment is the dollar amount of such payment less the savings in borrowing costs Treasury enjoys by receiving the payment earlier in time.

Two elements are critical in determining the present value of future revenue. First, one must know when, in the future, the revenue will be received. The later the payment, the smaller its present value. This is because the savings in borrowing costs that accrue during the time between the present time and the time of receipt grow daily.

The second key element of the present value formula is the cost of borrowing funds. The higher the borrowing cost, the smaller the present value of a future payment. This is because borrowing costs between the present time and the future payment date will increase as the borrowing rate rises. Consequently, Treasury could accept a smaller payment today in exchange for the future receipt.

The importance of timing

Exhibit III presents the percentage gain to Treasury from allowing a deduction for reclamation costs later in time (i.e., in the year of performance versus the year of obligation) under a variety of interest rate/time span assumptions. These percentage differences are all positive, indicating that deferral of a deduction will always benefit the Treasury. Treasury's analysis implicitly assumes no inflation coupled with a constant 12 percent after tax cost of money. The use of a 12 percent after tax rate, as contrasted with a lower rate, overstates Treasury's benefit.

The obvious question is which percentage change is most representative of what will actually occur. Treasury's borrowing rate in excess of the inflation rate is unlikely to be more than 4 percent for the rest of the 80's. For example, Data Resources Incorporated, the largest economic forecasting consultant, currently projects only a 3.2 percentage point difference between the consumer price index and the rate on short term

Treasury bills in 1985. Combining a 4 percent borrowing rate with a six-year time span between the obligation and performance dates (i.e., the time differential used by Treasury in their testimony on S.2642) suggests that Treasury will view deferral of the deduction as enhancing revenues from this item by 21%. This percentage enhancement is considerably less than Treasury implies.

Treasury's exaggeration of the value of deferral

The Treasury's testimony on S.2642 includes a series of specific calculations that purportedly illustrate the impact of reclamation deductions on production costs. An examination of these calculations suggests that Treasury assumed an excessively high cost of borrowing for the producer, which resulted in a gross exaggeration of the difference arising from the timing of the deduction. It is probably appropriate to use a before-tax producer cost of borrowing in excess of inflation of 6-8 percent. Previously, we indicated Treasury could expect to borrow at a rate no more than 4 percent greater than inflation. That rate is understandably lower than the 6-8 percent suggested for the producer because loaning money or providing equity capital to producers must be viewed as riskier than loaning money to the Federal Government, thus the producer must pay an appropriate risk premium. In their analysis, however, Treasury implicitly assumes no inflation, and a constant 12 percent after tax cost of money.

If Treasury believes that producers borrow at a 20 percent before tax interest rate, then they implicitly are assuming at least a 15 percent cost of borrowing for themselves. At this level, the difference between deducting the reclamation costs in the seventh instead of the first year results in a 56.8 percent increase in the value of the revenues received by Treasury. Comparing this gain to the 21.0 percent gain above suggests that Treasury's assessment of the gain is 270 percent of what it should be.

3. THE INDIRECT EFFECT OF DELAYING THE DEDUCTION

Delaying the deduction for reclamation costs until the work is performed would indeed result in increased revenues for the Treasury in the short run. Furthermore, the testimony of Treasury on S.2642 indicates that the producer may be able to absorb some or most of the higher taxes.

In fact, as in most industries, cost increases, including tax increases, result in higher product prices and reduced demand. Therefore, a contraction of output will occur which causes a decrease in the tax revenues of the Treasury. This indirect reduction in revenues further narrows the distinction between the alternative deduction methods; however, Treasury completely ignores it.

CONCLUSION

In conclusion, our views on this important issue remain unchanged from those expressed in our earlier testimony. The concern for a potential loss of revenue to the Treasury must pale by comparison to the added economic and financial burdens that would be placed on the mining industry if taxpayers are not permitted to deduct accrued reclamation obligations until the actual reclamation work is performed. The weight of judicial authority and even the Treasury's own regulations support the result of this proposed legislation.

S.237 has very narrow implications since it is limited solely to the special factors in the mining industry where, by law, the liability for reclamation costs is clearly established from the moment the land is disturbed. Thus, we fail to understand Treasury's concern regarding a broad application of S.237.

Thank you for your courtesy and attention during my presentation.

Exhibit I

ARTHUR ANDERSEN & Co.

1345 AVENUE OF THE AMERICAS
NEW YORK, N.Y. 10105

UNITED STATES SENATE
Committee on Finance
Subcommittee on Energy and Agricultural Taxation

Hearings on December 7, 1982 on:

Mining Reclamation Reserve Act of 1981 (S. 1911)

Comprehensive Mining Reclamation Reserve Act of 1982 (S. 2642)

Testimony by:

Peter R. Lasusa, Partner, Arthur Andersen & Co.

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TESTIMONY BY PETER R. LASUSA
ON
S.1911 AND S. 2642

INTRODUCTION

Good morning. My name is Peter R. Lasusa. I am a partner in the accounting firm of Arthur Andersen & Co. I have been asked to review the tax and accounting status of mine reclamation expenditures and I am appearing today on behalf of Bear Creek Uranium Company. While we are representing Bear Creek Uranium Company, I feel the positions set forth below are applicable to the entire mining industry. Thank you for giving me this opportunity to speak before this subcommittee on an issue of great importance to our nation's mining industry.

Arthur Andersen & Co. has had significant financial and tax accounting experience in the mining industry. Our clients include many of the nation's major mining companies. I, myself, have been involved in the financial and tax aspects of the mining industry for over 14 years. During the past several years, I have been the firm-wide industry head for mining which involves consultation with other professionals on mining industry questions, as well as serving as an expert witness in arbitration matters relating to mining.

S. 1911 and S. 2642

This subcommittee is addressing two pieces of legislation which deal with the tax treatment of mine reclamation expenditures; namely, the Mining

Reclamation Reserve Act of 1981 (S. 1911) introduced by Senators Arlen Specter and Robert C. Byrd, and the Comprehensive Mining Reclamation Reserve Act of 1982 (S. 2642) sponsored by Senator Malcolm Wallop and cosponsored by Senator Steven D. Symms. The principal difference between the two bills involves the methods used to recover the costs of reclamation once the liability has been established. S. 1911 would permit mine operators to deduct the accrued reclamation costs ratably over the life of the mine. S. 2642 would maintain the flexibility allowed under the current tax law. It would give taxpayers the option of deducting the costs of reclamation (i) on an "as disturbed" basis, i.e., the deduction is allowed only to the extent that the land is disturbed at year-end, or (ii) on a ratable basis.

I will limit my comments to S. 2642, since it incorporates the provisions of S. 1911 and, in addition, provides an approach that is soundly based upon Treasury regulations and court cases, and the immmediate recording of the liability is consistent with generally accepted accounting principles.

RECLAMATION LAWS

Under both Federal and state laws, surface mine operators are required to reclaim the land that has been disturbed by the mining process. A mine operator cannot begin mining until his comprehensive reclamation plan has been approved. Generally, the operator must post a performance bond to guarantee that the approved reclamation plan will be carried out. Noncompliance can result in civil and/or criminal penalties. Under these rules the operator has a fixed and certain legal liability to pay the costs of reclaiming the land and that obligation arises as soon as the land is disturbed.

IMPACT ON THE MINING INDUSTRY

Today, the mining industry, which I believe is critical to our nation's economic well-being, is in a depressed state. The uncertainties involved in mining operations, together with its capital requirements, make this industry a high risk business.

One of the problem areas which S. 2642 will help to solve involves the ability to generate needed capital to fund mine projects. Allowing taxpayers to deduct the reclamation costs when the liability is incurred will have a beneficial impact on the industry's cash flow. In view of the foregoing, I believe that this is an appropriate method of deducting such costs from a tax standpoint.

Furthermore, the long-running controversy between the Internal Revenue Service and the surface mining industry has created an atmosphere of uncertainty as to the proper tax treatment of reclamation costs. This uncertainty has had a negative impact on our nation realizing the full potential of our natural resources. In analyzing the financial aspects of a mine project, the tax treatment of reclamation costs can be a significant factor in determining whether or not a project is economically sound. Rather than risk litigation with the Internal Revenue Service, taxpayers, in evaluating the cash flow and other financial aspects of a particular mining venture, would likely apply the Internal Revenue Service's method of handling such costs with the result that many projects are found to be uneconomical and, thus, are "shelved." I do not believe that such results are consistent with our national goal of minerals and energy independence.

Enactment of S. 2642, which is intended to codify the current case law, will eliminate a significant area of uncertainty in planning mining operations; thus, reducing some of the risks inherent in this industry.

ACCOUNTING RULES

For financial accounting purposes, a liability is an obligation that must be satisfied through the disbursement of assets or the performance of services. A liability is recorded as soon as its existence is certain. Even if the exact amount of the liability and the date payable is unknown, once the existence of the liability is certain it should be recorded. Thus, with respect

to mine reclamation expenses, generally accepted accounting principles require that the costs that will be incurred to comply with the mine operator's liability to reclaim the land, be recorded as soon as the liability exists, i.e., as soon as the land is disturbed.

TAX LAW

This same concept -- the fact that a liability exists even though the exact amount and date payable may be uncertain -- is provided in the Treasury Regulations relating to the timing of tax deductions for accrual basis taxpayers. Treasury Regulation §1.461-1(a)(2) provides that an expense is deductible in the tax year in which:

1. All events have occurred which determine the fact of liability; and

2. The amount of the liability can be determined with reasonable accuracy.

Thus, under existing income tax regulations, an accrual basis taxpayer may deduct an expense in the year that the fact of liability is established so long as the amount of the liability is then susceptible of reasonable determination.

Pursuant to the requirements of both Federal and state law, a mine operator has a fixed requirement to reclaim all land disturbed in the mining process, and that liability arises when the land is disturbed. The first requirement of the regulations, i.e., that the liability be established, is met immediately when the land is disturbed. The second requirement of the regulations, i.e., that the amount of the liability be determined with reasonable accuracy, is satisfied through engineering studies or through consultation with experts in reclamation work. The cost of the liability should be re-determined annually based upon facts and circumstances in existence at year end.

Despite its own regulations, the Internal Revenue Service has taken the position that reclamation costs are deductible only when the reclamation work is actually performed. This position effectively puts all taxpayers on a cash basis with respect to mine reclamation expenses. The courts have tended to reject the Internal Revenue Service's position and have recognized the validity of deducting accrued reclamation costs when the obligation becomes fixed, i.e., when the earth is disturbed. See Denise Coal Company v. Commissioner, 271 F.2d 903 (3rd Cir. 1959), Commissioner v. Gregory Run Coal Co., 212 F.2d 52 (4th Cir. 1954), cert. denied 348 U.S. 828 (1954), and Patsch v. Commissioner, 19 T.C. 501 (1952), aff'd 208 F.2d 532 (3rd Cir. 1953). Recently, the Tax Court in Ohio River Collieries Co. v. Commissioner, 77 T.C. No. 103, reversed an earlier decision, Harrold v. Commissioner, 16 T.C. 134 (1951), rev'd 192 F.2d 1002 (4th Circ. 1951), and its position is now in accord with the United States Courts of Appeals that have decided the issue.

This legislation would eliminate the uncertainty caused by the failure of the Internal Revenue Service to follow its own regulations and the decisions of the courts.

CONCLUSION

We strongly urge Congress to codify the rule of the regulations and the current case law. The position taken by the Internal Revenue Service, that a taxpayer may not deduct its accrued reclamation obligation until the reclamation work has actually been performed, is not consistent with the tax law. It is also inconsistent with the fundamental accounting principle that a liability should be recorded when known, i.e., when the land is disturbed and when it can be fixed in an amount with reasonable accuracy. The need for development of our natural resources and for restoration of our lands disturbed by surface mining makes it imperative that we do not permit disincentives of these national priorities.

In conclusion, we believe that the Court of Appeals in Denise Coal Company, supra, sets forth our views quite succinctly. "We think it is good business and good accounting and, therefore, ought to be good tax law to allow a reasonable estimate to be set up as a reserve for the fulfillment of this statutory obligation."

Thank you for your courtesy and attention during my presentation.

EXHIBIT II

For Release Upon Delivery
Expected at 10:00 a.m. EST
December 7, 1982

STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY
(TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
OF THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on S. 1911 and S. 2642, which would permit both cash and accrual method taxpayers to deduct the estimated cost of surface mining reclamation work in a taxable year prior to the year such work is performed. For reasons that I will discuss, Treasury is strongly opposed to both of these bills.

Background

The Surface Mining Control and Reclamation Act of 1977 and similar state laws require surface mine operators to restore land that is damaged by the mining process. In many cases the mine operator either must post a bond to insure his future performance of the required reclamation work or otherwise must demonstrate financial capability to perform the required reclamation work after mining activities are completed.

S. 1911 and S. 2642 are an outgrowth of a controversy which has existed for some time between mine operators and the Internal Revenue Service over the proper time to accrue deductions for the cost of statutorily mandated reclamation work to be performed in the future. The Service takes the position that such expenses are not accruable until the taxpayer incurs a present liability to pay for the reclamation work. Taxpayers argue that the estimated amount of the reclamation expenses should be deductible when the statutory obligation to perform the reclamation work arises.

In a recent decision, the Tax Court held that the estimated expenses of an accrual method taxpayer to be incurred in future taxable years to satisfy its statutory obligation to reclaim strip-mined land were accruable during the year of the mining operation, even though reclamation work had not been started and the taxpayer had no present liability to pay for the performance of such work. Ohio River Collieries Co. v. Commissioner, 77 T.C. 1369 (1981). S. 1911 and S. 2642 would codify the Tax Court's decision on this issue for accrual method taxpayers and would provide similar treatment for cash method taxpayers.

Description of S. 1911 and S. 2642

S. 1911 and S. 2642 would permit both cash method and accrual method taxpayers, in computing taxable income for any year, to elect to deduct a reasonable addition to any reserve established for the estimated expenses of surface mining land reclamation. The election would be made on a property-by-property basis. For this purpose the term "property" has the same meaning as in section 614 of the Code; that is, each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land is treated as a separate property. The estimated expenses would be allocated to the minerals extracted. Thus, the accrued reclamation expenses would be deducted over the life of the mine as minerals are produced.

The primary difference between the two bills is that S. 2642 also would allow a taxpayer to elect to allocate estimated expenses to the property "disturbed" rather than to minerals extracted. This would mean that expenses could be deducted as the land is "disturbed." S. 2642 does not clarify what types of "disturbance" would give rise to the deduction.

The bills define the "estimated expenses of surface mining land reclamation" as those expenses otherwise deductible under the income tax law which are (1) attributable to "qualified reclamation activities" to be conducted in future years, (2) are subject to estimation with reasonable accuracy, and (3) are either allocable to minerals extracted before the end of the taxable year (or, in the case

of S. 2642, are allocable to that portion of the property disturbed in the taxable year). The term "qualified reclamation activities" is defined as land reclamation activities conducted under a reclamation plan submitted as part of a surface mining permit application under the Surface Mining Control and Reclamation Act of 1977 or under a plan submitted pursuant to a Federal or State law imposing substantially similar surface mining land reclamation requirements. If the amount in any reserve for estimated expenses of surface mining land reclamation is determined to be excessive at the close of any taxable year, then the excess shall be included in gross income in that year. Nonqualified land reclamation expenses of electing taxpayers would be deductible in accordance with regulations to be prescribed by the Secretary.

S. 1911 and S. 2642 also provide special treatment for estimated expenses of surface mining land reclamation that are attributable to mining activities occurring before the first taxable year for which the reserve accounting method is elected and that have not previously been deducted. These estimated expenses are treated as deferred expenses and may be deducted ratably over a 60-month period beginning with the first month of the first taxable year for which reserve accounting is elected. If mining of a property with respect to which there are deferred expenses will be completed in less than 60 months, then the expenses can be deducted ratably over that shorter period.

The bills generally would be effective for taxable years ending after the date of enactment. However, they also would validate retroactively the deduction of these estimated future expenses for accrual method taxpayers who have accrued such expenses for one or more taxable years ending on or before the date of enactment.

Discussion

S. 1911 and S. 2642 deal with a problem of income measurement that is not unique to the mining industry. Taxpayers often generate income in one year and incur an expense directly associated with generating that income in a subsequent year. Indeed, generally accepted accounting principles frequently require the establishment of reserves for such future expenses, thus reducing net profit as reported on financial statements.

At first glance, there is some appeal to taxpayers' claims that they should be entitled to current deductions for these future expenses. The true profit from any income-producing activity can only be determined by taking all related expenses into account. Nevertheless, there are three broad considerations that militate against permitting current deductions for future expenses. First, a rule that grants a

deduction today for tomorrow's expense overstates the true cost of the expense to the extent that the rule fails to take into account the time value of money. Second, such a rule is difficult to administer, since estimates of future expenses are inherently uncertain. Finally, the revenue loss from such a rule, applied evenhandedly to all similarly situated taxpayers, would be prohibitive.

The first of these problems -- the overstating of the true cost of the future expense outlay -- is best demonstrated by example. Assume the taxpayer generates $100 of income in year 1 from an activity which will generate a corresponding expense of $100 six years later (year 7). If the taxpayer is permitted to accrue the $100 expense, he will report no net income from the activity. But since the taxpayer has the unfettered use of the $100 of income beginning in year 1, at the end of six years he will have substantially more than $100 with which to pay the expense. If he has been able to earn a 12 percent after-tax return on the funds during the six-year period, he will have about $200. The problem lies in the fact that the true cost in year 1 of the future outlay is the present value of the outlay amount, which in this case is about $50. Thus, the taxpayer's true profit in year 1 is $50 ($100 income less the $50 present value of the future expense), and the appropriate tax (assuming a 50 percent tax rate) is $25. Unfortunately, our present income tax system does not reach this result because it does not take into consideration the time value of money.

Conversely, delaying the taxpayer's deduction to year 7 always produces the correct result. In reality what has happened is that the taxpayer has charged $50 for the product sold and $50 to fund his future obligation seven years hence.* This latter $50 will bear a $25 tax in year 1 and the remaining $25 will grow to $50 in year 7, which will equal the taxpayer's net after-tax cost ($100 expense less $50 tax savings) of the obligation in year 7.

While deferring the tax deduction to the year in which the expense is incurred thus produces the correct result, the taxpayer in some cases may have insufficient income in the later year against which to offset the deduction. The net operating loss carryback provisions will not remedy the situation if the taxpayer had insufficient income in the taxable years to which the deduction can be carried back. If

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*A detailed discussion of the effect of the timing of the deduction for the future obligation on the amount charged to fund that obligation is set forth in the attached appendix.

the taxpayer is forced to carry the loss forward, the value of the deduction will decline in present value terms. If relief is considered necessary, then the appropriate solution would be to amend the net operating loss provisions to provide for a longer carryback period in the case of losses of the type at issue here, as has already been done in the case of product liability losses under current law.

A second inequity with deferring the tax deduction may arise when the taxpayer is required to escrow funds currently to meet the future obligation but the taxpayer is not entitled to receive the benefit of a market rate of interest earned on the escrowed funds. However, if the taxpayer is denied such interest on the escrowed funds, his economic disadvantage is caused by the terms of the escrow arrangement rather than by the Federal tax law.

There is precedent in the tax law for reserve accounting methods of the type provided by S. 1911 and S. 2642. The Internal Revenue Code of 1954, as originally enacted by Congress in 1954, contained a provision, section 462, which permitted the accrual of current deductions for future expenses attributable to income generated in the current year. This provision was repealed, retroactively, in 1955. Even though section 462 was consistent with generally accepted accounting principles, the administrative problems and potential revenue losses caused by the provision were found to be intolerable shortly after enactment of the 1954 Code. It was simply impossible to impose any workable limitations on the categories or amounts of the future expenses for which reserves could be established and current deductions claimed, and the potential revenue losses from allowing all similarly situated taxpayers to create and deduct such reserves were unacceptable.

The foregoing discussion makes it clear why Treasury opposes S. 1911 and S. 2642. The mathematical examples show that the denial of current deductions for future reclamation expenses required by Federal or State statutes penalizes taxpayers only to the extent that the taxpayers are unable to obtain immediate tax benefits from the deductions in the year the expense outlays are made. This hardship, if it exists at all, is minimal compared with the unfair advantage that would be given to mining companies by allowing current deductions for the undiscounted amount of the future outlays.

Moreover, the enactment of either of these bills to give special treatment to mining companies would have broad implications with respect to the deductibility of reserves for similar expenses incurred by other taxpayers. If current deductions are allowed for estimates of future reclamation expenses, it would be difficult to deny taxpayers the right to establish reserves for the estimated amount of workers'

compensation costs, product liability and warranty claims, unfunded pension liabilities, costs of dismanteling offshore drilling rigs or decommissioning nuclear power plants, and the like. The past experience with the broad rule of section 462 of the 1954 Code shows that the potential revenue losses from applying this accounting method to similarily situated taxpayers would be prohibitive.

Proponents of S. 1911 and S. 2642 argue that our concerns in this area are rendered moot by the Ohio River Collieries case, and that the legislation merely codifies current law as to the appropriate time to accrue reclamation expenses. We disagree. We believe that Ohio River Collieries was incorrectly decided and that the "all events" test for accruing deductions under current law does not mandate the results provided by the two bills. Rather, we believe that current law allows a deduction for reclamation expenses only when the taxpayer has a present liability to pay for such expenses. However, if legislation is needed to eliminate the uncertainty resulting from the current conflict between the Internal Revenue Service and taxpayers on this issue, the legislation should confirm the correctness of the Service's position and eliminate the ability of mining companies to understate their incomes in the manner allowed by the Ohio River Collieries case. In the interim, we intend to continue litigating cases such as Ohio River Collieries in order to assure consistent application of the "all events" test of present law.

Finally, regardless of the argument that can be made as to the proper time for accrual method taxpayers to deduct future expenses, there can be no debate about the appropriate time for cash method taxpayers to deduct these expenses. The law has been consistently clear that a cash method taxpayer can only deduct an expense when he has actually paid it. We strongly object to the provisions in both S. 1911 and S. 2642 that would permit an exception to this longstanding rule.

Conclusion

Treasury strongly opposes S. 1911 and S. 2642. The bills would permit mining companies to understate their incomes significantly by claiming current deductions for the undiscounted amount of future expense outlays. More importantly, enactment of either bill would open the way for additional legislation to permit other taxpayers to establish reserves for the estimated amount of future expenses associated with current income-producing activities. The bills should not be viewed as merely codifying existing case law in a discrete area.

I would be happy to answer your questions.

Appendix

Analysis of Alternative Tax Treatments Of Deferred Expenses

I. Nature of the problem

It is frequently the case that a current exchange of goods and services entails completion of a future action by the seller. When that future action requires the expenditure of resources by the seller, the question arises as to whether those expenditures should be taken into account in determining the seller's current year pre-tax or taxable income. The correct answer to this question is a rule which ensures that the amount charged by the seller reflects no more than the resource cost of completing the transaction. The purpose of this Appendix is to demonstrate that the present law rule which requires that the seller include in his gross income for the current year the entire proceeds of his sale while deferring to the later year the deduction of the associated expense generally produces the correct result. The analysis also identifies the error implicit in an alternative rule that would permit the seller to currently deduct the future cost.

The exposition following includes: first, a description of the determination of the price to be charged absent the influence of income taxation; second, a measure of the seller's income in the year a sale is made which requires a future year expenditure; third, a demonstration that the present law rule does not affect the current year price charged; and finally, an identification of the logical error in formulation of the alternative rule under which the seller's current year taxable income is measured as the sales price less the future cost of completing the transaction. The facts of the example used in the testimony will be used to provide numerical results.

II. Determining the current year price to be charged a buyer of goods or services when the seller becomes obligated to incur a future expense.

If all a coal mining company must do to produce a ton of coal for sale is mine it and otherwise prepare it for delivery to a buyer, the price charged would have to be sufficient to cover all the expenses incurred in its production: wages of coal miners, the cost of materials consumed in mining, and a gross return to mining company capital sufficient to cover depletion of its reserves, and depreciation of its equipment and to provide a return to its creditors and equity owners. Since the price to cover all these costs of production multiplied by the quantity

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mined is reported by the mining company as "gross income," the company is allowed to deduct the wages paid and the cost of materials used up, since these elements of gross income are allocable to those productive agents. The coal company is similarly permitted to deduct depletion and depreciation costs to determine pre-tax income. After the mining company deducts the interest paid creditors--their share of the pre-tax income from capital employed in the mine--the residual is the pre-tax income of equity owners. Taxation affects the cost of mining coal only to the extent it affects the cost of wages or materials or the pre-tax rates of return of creditors and equity owners. So long as costs incurred in simple mining are appropriately measured and allowed as deductions to the mining company, the income taxation of coal mining companies, per se, does not affect the price of coal.

Now suppose that, in addition to incurring these current costs of mining coal for sale, the mining company must also restore the land to some specified condition after mining is completed. Clearly, an additional cost to the mining of coal has been imposed. Since this future reclamation expense is effectively independent of the mining cost, it can be isolated in determinating its effect on the price of mined coal. Let us symbolize the cost to be charged coal buyers for this service as P_1, the subscript indicating that it is a price to be charged in year #1, when the coal is mined.

If we symbolize the future outlay to reclaim the mined land as O_n, the subscript indicating the year when the reclamation outlay will be made, then the only other determinant of P_1 is the discount rate by which the current year charge can be related to the future outlay. Let us call this discount rate, which is the opportunity cost of shifting payment obligations over time, r. Then, ignoring taxation,

$$P_1 = O_n (1+r)^{-(n-1)}. \qquad (1)$$

That is, referring to the example in the testimony, where O_n = \$100, n=7 and r= 0.12, P_1 = \$100(1.12)$^{-6}$ = \$50.66. The seller would have to charge the buyer at least \$50.66 in year #1 so that, 6 years later, he would have accumulated \$100 with which to cover the costs of reclamation (in year #7). From the buyer's point of view, he would pay no more than \$50.66 in year #1 for he could take that capital sum and accumulate it over 6 years to \$100 and, himself, requite the reclamation cost of \$100.

III. The seller's income.

Suppose that the cost assumptions of the above example hold. What is the measure of the coal miner's income in year #1 when he receives the \$50.66? Obviously, with respect to the \$50.66 received for the sale of coal, it is zero: He has simultaneously received a market payment of \$50.66 but

incurred an obligation to cover a future expense the present value of which is exactly equal to $50.66. Therefore, for financial statement purposes, the receipt of the $50.66 has no effect on the company's income statement; but it will have a balance sheet effect. On the balance sheet, the $50.66 will be an increase in assets (earning 12 percent, by assumption) offset by the recognition that there is a future $100 obligation, less a "discount" of $49.34, which represents the 6-year cumulation of earnings of the $50.66. With each passing year, the mining company will record interest income and a corresponding decline in the "discount" associated with the year #7 reclamation obligation. If it does not in fact accumulate among its assets the interest earned, when the $100 outlay is made the mining company will suffer a $49.34 decline in net worth.

IV. Introducing income taxation.

In order to simplify exposition, we shall now assume the r in equation (1) represents an after-tax rate of return to capital employed in the enterprise. There are two income tax formulations for the treatment of P_1 that will give the same result as equation (1): The present law rule, and another rule which applies the result in III, above, namely, that there is zero pre-tax income in year #1.

First, we rewrite equation (1) to introduce an income tax levied at rate m. If T_1 = tax due in period #1 and T_n the tax due in period n,

$$P_1 - T_1 = (O_n + T_n)(1+r)^{-(n-1)}. \qquad (2)$$

Symbolically, equation (2) simply says that P_1, less tax due when it is received, must be equal to the future outlay, plus tax then due, when the outlay is made in year n, all discounted to the present.

Under present law, which taxes P_1 as received and allows a deduction of O_n in year n,

$$T_1 = mP_1 \qquad (3a)$$

$$T_n = -mO_n. \qquad (4a)$$

If equations (3a) and (4a) are substituted in equation (2), the result is:

$$P_1(1-m) = O_n(1-m)(1+r)^{-(n-1)},$$

which, of course, is exactly the same as equation (1) after cancelling the (1-m). Applying the present law rule to the factual assumptions in the testimony example produces a P_1 = $50.66, and if we take m = 0.40, $20.26 will be paid in tax (T_1=$50.66 x 0.40) leaving the miner a capital fund of $30.40

which will accumulate to $60 in year #7, at which time the miner will receive a refund of $40 ($T_7$ = -$100 x 0.40) enabling him to cover the $100 year #7 cost.

Of course, if the taxpayer is allowed a $50.66 deduction in year #1 against his P_1 = $50.66 to signify his lack of economic income in that year and is not allowed to take a deduction when the expense is incurred in year #7, T_7=0, the same result is achieved as under present law, and neither rule causes an alteration in the charge for reclamation. But note that, in order to apply the latter rule, the present value of the future cost must be determined, and this requires estimation of a discount rate. In contrast, the present law rule which taxes P_1 and refunds with respect to O_n operates only with actual transactional data and requires no discounting.

V. The effect of erroneously permitting the current deductibility of future (undiscounted) costs.

Suppose we define P_1' to be the year #1 charge for future costs to be incurred by the seller under a tax rule that will permit the amount of the future outlay, O_n, to be currently deducted. Then,

$$T_1 = m(P_1 - O_n) \qquad (3b)$$
$$T_n = O, \qquad (4b)$$

and substituting these in equation (2) and simplifying, we obtain

$$P_1 = O_n[(1+r)^{-(n-1)} - m]/(1-m). \qquad (4)$$

In contrast with P_1 as determined under present law rules for P_1 and O_n, this rule makes P_1' a function of the tax rate m. In general, for all tax rates greater than zero $P_1' < P_1$, the difference being a tax subsidy to benefit the cause of the deferred expense; it results from the deduction of an undiscounted amount O_n, in year #1, and the subsidy increases with the taxpayer's marginal rate.

For example, continuing to use the testimony example in which $50.66 is the true charge for reclamation a buyer of coal should pay, allowing current expensing of $100 would result in the following:

	P_1 Buyer's reclamation charge	Subsidy ($50.66-$P_1$)
Miner's tax rate:		
0.20	$38.33	$12.33
0.40	17.77	32.89
0.46	8.64	42.02

Of course, if competition does not drive down the reclamation charge to miners' customers, the subsidies will be converted into increased monopoly profits of miners. If for example, a monopolistic corporate miner keeps the charge at $50.66, this will increase its after-tax monopoly profit by $22.69 (=the "refund" on $50.66 of current income, less $100, times 0.46), equivalent to a taxable subsidy to him of $42.02, as shown above.

EXHIBIT III

Percentage gain to Treasury generated by deducting reclamation costs when performed versus when obligated.

Years between Obligation and Performance	Excess of Treasury borrowing rate over inflation rate			
	2%	3%	4%	5%
1	2.0	2.9	3.9	4.8
2	3.9	5.7	7.5	9.3
3	5.8	8.5	11.1	13.6
4	7.6	11.2	14.5	17.7
5	9.4	13.7	17.8	21.7
6	11.2	16.3	21.0	25.4
7	12.9	18.7	24.0	28.9
8	14.7	21.1	26.9	32.3
9	16.3	23.4	29.7	35.5

Senator WALLOP. Thank you, Mr. Lasusa.

Don, I know last year you had your own bill and you, as I, have been interested in seeing this problem resolved in some kind of a timely manner. Let me ask you, is there any question at all in your mind that these accrued expenses fit into that all-events test that is required by the code?

Mr. BAILEY. No; there is absolutely not.

Senator WALLOP. And we are not thinking, I would not think—and I do not know mining as well in your State as in mine, but I would assume that our laws are not that different, and especially since we operate under the Federal Surface Mining Act, they are not that different.

If these are deductible on an as-disturbed basis, you are only talking about 2 or 3 years before you are back. You are not talking 20 years, I do not think. The obligation begins to materialize quite quickly as you move into the mining process, does it not?

Mr. BAILEY. Yes, it does, Senator. In fact, our laws in Pennsylvania are more strict in some ways than the Federal standard, and we have a very large number of small operations that mix into the strip area in a number of different ways. What you said is absolutely correct.

Senator WALLOP. So that the predictability of those number of years is really less challengeable there than in any other kind of example that they were using.

Mr. BAILEY. That is correct.

Senator WALLOP. You are not very far away from reality in that one.

Mr. BAILEY. They are very weak to nonexistent arguments, particularly in light of the fact of what they did in the Ohio case. They do not really, aside from coming here to the committee and testifying, I do not think that IRS would make a serious argument on actually estimating costs. They cannot do it.

Senator WALLOP. Well, I am interested in that because, as you noted, when it really finally came down to it, their argument was really not the all-events test, but the time value of money.

And I would ask you, Mr. Lasusa, with your firm and its experience, if there is any way efficiently to incorporate a concept like that into the Tax Code, especially given his desire, expressed desire for symmetry between the income and expense part.

Mr. LASUSA. At present, the way the *Collieries* case was handled, Senator, that said that the liability existed and the costs were reasonably estimable and therefore the company was entitled to the deduction, and there have been two or three other cases that have supported that.

Senator WALLOP. But even there, assume for a minute that somehow or another they will end up proving their point with the courts. And I do not think they will, but assume that. I am talking about this whole concept that Mr. McKee has expounded on behalf of Treasury here, that we now incorporate the time value of money into the Tax Code. And he was suggesting that we have some symmetry in that and attach the idea of income as well as deduction, expenses for deduction.

Can you see any efficient way to incorporate a concept like that into the Tax Code?

Mr. LASUSA. We would not even do it on income and expenses that fall in the same year, because there are time values as to whether you get the income in the first month of a year or the last month of the year. It just would be beyond comprehension, trying to solve that problem.

Senator WALLOP. Well, I want to thank you both for your testimony here this afternoon. We appreciate your coming down. It was good to see you again, Don.

Mr. BAILEY. It is good to see you, Senator. Thank you very much.

Senator WALLOP. Now we have a panel consisting of: Mr. Dennis Bedell, chairman of the tax committee of the American Mining Congress, on behalf of the Congress; Mr. Dwight Keating, vice president of the Grafton Coal Co., Clarksburg, W. Va., on behalf of the Mining and Reclamation Council of America; Mr. Joseph Nicholls, senior vice president, administration, of Drummond Coal Co., on behalf of the National Coal Association; and Mr. Robert Penoyer, chief executive officer of the SRP Coal Co., on behalf of the Pennsylvania Coal Mining Association.

And Mr. Turnock, since they will be testifying on both S. 1006 and S. 237, and since you would seem to be lonely up here as only one witness and the last one, why don't you just come and join them and we will get all of this together.

Mr. Turnock is president of the American Iron Ore Association, and he is accompanied by Mr. John Kelly, chairman of the Association's Tax Committee.

So Mr. Bedell, please go ahead.

STATEMENT OF DENNIS P. BEDELL, CHAIRMAN, TAX COMMITTEE OF THE AMERICAN MINING CONGRESS

Mr. BEDELL. Thank you. I am Dennis Bedell and I appreciate the opportunity to appear before you today on behalf of the American Mining Congress.

At the outset, let me reiterate our appreciation for the efforts which you and your colleagues who have cosponsored S. 237 are making to bring a degree of sound administration of the tax laws to the area of mine reclamation expenses. As we said last December at your hearings at that time, since the courts have concluded that the estimated expenses of future mine reclamation are currently deductible when the land is disturbed, the effect of your legislation is not to extend some new treatment, but simply to eliminate needless controversies between the Revenue Service and taxpayers. It is simply to say to the Revenue Service, "Follow the principles that have been articulated by the courts, such as in the *Ohio River Collieries* case."

I would like to comment on the reasons of the Treasury for opposing this legislation, which really are basically two: First, Treasury opposes S. 237 on the basis that it violates the principle of a pristine accounting system that future income and expense must be present valued to accurately measure income.

The basic problem with that argument is that it is so pristine that it is found nowhere else in the tax law or even, indeed, in the body of generally accepted accounting principles, as Mr. Lasusa indicated, which we use for all other purposes to measure income

and expense and reflect the results of that for regulatory purposes and financial reporting purposes.

It is very difficult for us to see why the area of mine reclamation expenses should be subjected to a requirement of this nature that is not posed or utilized in testing the validity of any other type of treatment for accounting purposes or for tax purposes.

Second, Treasury opposes the bills on their floodgates argument and raised the specter of section 462, which was enacted and repealed in 1954 and 1955. Their argument is that if current deductibility is accorded to mine reclamation expenses, then there is a host of other types of future expenses that must be accorded similar treatment, at a great revenue cost.

I would suggest this argument suffers from some very fundamental defects, not the least of which is the fact that, as I indicated, S. 237 is not extending present law. It is simply clarifying or codifying what the courts have said present law is. In the case of other types of expenses, and particularly product warranty expenses, the courts have not yet decided that under present law, under the all-events test, there is current deductibility.

When the courts do so decide, that may well be the occasion to accord legislatively similar clarification if the Revenue Service continues to be obstinate. But that is not the case now. The case is that the courts have concluded that current deductibility is proper for mine reclamation expenses under current law, and that is what would be clarified by your bill.

Second, Mr. McKee suggested that it is very difficult to estimate what the amount of the future expense is and therefore the legislation would bring a great deal of uncertainty into the tax law. As has been noted, that just is not correct. There is a track record with respect to mine reclamation expenses. There is the requirement of the performance bond and a number of means by which the reasonableness of the future estimate can be validated, which is not necessarily true in the case of other types of expenses.

Accordingly, Mr. Chairman, we urge the committee to act favorably and promptly on S. 237 so that this area of uncertainty can be eliminated.

I would like to comment also on S. 1006, which would repeal the ill-advised 15-percent cutback in the coal and iron ore percentage depletion allowance which was enacted last year and is scheduled to take effect next year. Fortunately, through your efforts and those of Senator Specter, the effectiveness of this cutback was postponed until next year, in view of the very depressed state of the coal and iron ore industries.

And as you noted in your opening statement, that really has not significantly changed. More importantly, the percentage depletion allowance just on fundamental grounds should not be cut back. It has long served, for over 60 years, to recognize the basic characteristics of the mining industry, its high-risk nature, that it is tremendously capital intensive, that mining projects involve a long lead-time, and the fact that new sources of reserves are always more costly to develop and explore.

The percentage depletion allowance provides a needed source of capital in the industry to allow it to carry out its task of supplying our mineral needs, and so both from a short-term and a long-range

standpoint S. 1006 should be enacted so the percentage depletion allowance for coal and iron ore can continue to exist.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Bedell follows:]

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STATEMENT

OF THE

AMERICAN MINING CONGRESS

TO THE

SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

COMMITTEE ON FINANCE

UNITED STATES SENATE

BY

DENNIS P. BEDELL

CHAIRMAN, AMERICAN MINING CONGRESS TAX COMMITTEE

MAY 23, 1983

Mr. Chairman and Members of the Subcommittee:

My name is Dennis P. Bedell. I am Chairman of the Tax Committee of the American Mining Congress and a member of the Washington, D. C. law firm of Miller & Chevalier, Chartered.

I am appearing before you today on behalf of the American Mining Congress. We appreciate this opportunity to testify with respect to S. 237, regarding the treatment of mine reclamation expenses and S. 1006 regarding the coal and iron ore percentage depletion deduction.

The American Mining Congress is an industry association representing all segments of the mining industry. It is composed of (1) U. S. companies that produce most of the nation's metals, coal and industrial and agricultural minerals; (2) companies that manufacture mining and mineral processing machinery, equipment and supplies; and (3) engineering and consulting firms and financial institutions that serve the mining industry.

The American Mining Congress appreciates the efforts of the Chairman and others who have joined with him to statutorily clarify the tax treatment of mine reclamation expenses and, thus, to eliminate the needless controversies regarding the treatment of these expenses which continue to arise between mine operators and the Internal Revenue Service. In general, S. 237 seeks to accomplish this objective by including within the Internal Revenue Code the standards which the courts have developed with respect to the proper time for accruing mine reclamation expenses. To a large extent the bill would codify these traditional interpretations and thus remove from the realm of controversy the questions which can arise when the general standards of the Internal Revenue Code for the accrual of an expense are applied.

As we testified last year, it is important that the rules employed in S. 237 be enacted so that further needless controversies between the Internal Revenue Service and taxpayers regarding the deductibility of mine reclamation expenses can be minimized.

The courts have concluded that mine reclamation expenses are properly accruable when the mine operator first disturbs the land on which the mining operation is conducted. It is at this point that liability to restore the land arises under the mandates of federal and state law and, accordingly, it is at this point that the estimated expenses of the restoration activity are properly deducted for federal tax purposes.

Notwithstanding the position of the courts on this matter, the Revenue Service continues to challenge taxpayers' accrual of mine reclamation expenses, thus making the prompt enactment of S. 237 necessary from the standpoint of sound administration of the tax laws.

We are concerned that the Treasury Department has chosen to oppose the needed statutory clarification employed in S. 237. The Department attempts to support its position by suggesting that proper accounting requires a type of present valuing of mine reclamation expenses. It does not explain, however, why this one item -- mine reclamation expenses -- should be singled out for this unusual treatment when no other item of income or expense is similarly treated for federal tax purposes. Indeed, although this "present valuing" treatment is suggested to be needed to properly reflect income, the Department does not explain why no such treatment is found elsewhere in the tax law or even in the body of generally accepted accounting principles that govern the financial presentation of the results of mining and other public activities.

Treasury also suggests that if the Congress were to codify the treatment of mine reclamation expenses that has been sanctioned by the courts, this would lead to extending similar treatment to other types of future expenses. Such a result does not follow. There may well be other types of expenses that warrant similar treatment. The courts, however, have not yet found this to be the case as they have with regard to mine reclamation expenses. When the courts do reach a similar conclusion with respect to another type of expense, that would be the appropriate occasion to consider that other type of expense. S. 237 would simply specify that the Internal Revenue Service is to follow the principles that have been applied by the courts regarding the proper time for deducting mine reclamation expenses.

We also urge the prompt enactment of S. 1006 which would remove from the law the reduction in the percentage depletion deduction for coal and iron ore scheduled to take effect next year. This provision was mistakenly adopted as part of the 1982 TEFRA tax package without recognition of the very difficult situation in which coal and iron ore segments of our mining industry find themselves and without proper focus on the substantial role that the percentage depletion allowance plays in allowing the mining industry to carry out its important task of locating and making available to the nation the minerals on which our economy relies. It makes no sense to take away a portion of the depreciation allowance from these mining industries. This is particularly so in view of the quite depressed economic situation in which coal and iron ore mining companies presently find themselves. Accordingly, we urge that S. 1006 be adopted.

Senator WALLOP. Thank you, Mr. Bedell.
Mr. Keating.

STATEMENT OF DWIGHT KEATING, VICE PRESIDENT, GRAFTON COAL CO., ON BEHALF OF THE MINING AND RECLAMATION COUNCIL OF AMERICA

Mr. KEATING. Thank you, Mr. Chairman.

Mr. Chairman, I am Dwight Keating, vice president of Grafton Coal Co., Clarksburg, W. Va. I appear before the subcommittee today on behalf of the members of the Mining and Reclamation Council of America to testify in support of the immediate passage of your bill, Mr. Chairman, S. 237, the Comprehensive Mining Reclamation Reserve Act of 1983, and S. 1006, introduced by Senator Specter to amend the Internal Revenue Code of 1954 to repeal the 15-percent reduction in percentage depletion for coal and iron ore.

Both of these measures, Mr. Chairman, have the full support of my Senators, the Democratic leader of the Senate, Robert Byrd, and the ranking minority member of the Environment and Public Works Committee, Jennings Randolph.

Two points that I think are necessary: So far the Treasury has ignored the court's rulings and has placed a financial burden on small operators that is pretty large. Mr. Gentile when he testified last year on this case had legal and accounting expenses of $70,000 for an $85,000 deduction in his case.

And other small operators, like my company, have hired outside engineering firms to make estimates of this liability, outside law firms, and outside accounting firms, to keep us involved on this. And it is very expensive.

The Treasury had an opportunity to appeal this case to the Supreme Court and they decided not to. At the same time, they had the financial wherewithal to basically beat the small operator into the ground by rejecting their ruling, because we do not have the financial wherewithal to contest them all the time.

The second point I would like to make is in regard to the time value of money. In this context, I would like to read the Federal surface mining regulations mandating contemporaneous reclamation. This is from the Code, 816 100:

> Reclamation efforts, including but not limited to, backfilling, grading, topsoil placement and revegetation of all land that is disturbed by surface mining activities shall occur as contemporaneously as practical with mining operations.

So it has to be as contemporaneous as possible. This varies, depending upon the type of mining you do, the area of the country that you are in.

I will tell you one thing. From a practical business standpoint, I want to reclaim the land as fast as possible because it is the cheapest to do it. If I wait timewise and postpone, if I was allowed under the law, it becomes more expensive.

I calculate that reclamation liability in today's costs, not some theoretical cost of 4 years, 5 years, 2 years down the road. I do not know what those costs are, but I know what costs are today. And so far as my brief history in the mining industry, costs have been more expensive tomorrow than they are today.

So from a practical business standpoint, the smaller the reserve is, the more profitable my company is going to be.

That is my major comment on S. 237.

In regard to 1006, we feel the scheduled reduction is inequitable and inadvisable public policy at this time. MARC supports and urges the committee to enact S. 1006, introduced by Senator Specter, which repeals the scheduled reduction.

I appreciate your time for listening to us today.

[The prepared statement of Mr. Keating follows:]

STATEMENT OF DWIGHT KEATING, GRAFTON COAL CO., CLARKSBURG, W. VA.

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE, I AM DWIGHT KEATING, VICE PRESIDENT OF GRAFTON COAL COMPANY, CLARKSBURG, WEST VIRGINIA. I APPEAR BEFORE THE SUBCOMMITTEE TODAY ON BEHALF OF THE MEMBERS OF THE MINING AND RECLAMATION COUNCIL OF AMERICA (MARC), A NATIONAL TRADE ASSOCIATION REPRESENTING DOMESTIC SURFACE COAL PRODUCERS FROM ALL COAL PRODUCING REGIONS OF THE UNITED STATES, TO TESTIFY IN SUPPORT OF IMMEDIATE PASSAGE OF YOUR BILL, MR. CHAIRMAN, S.237, THE COMPREHENSIVE MINING RECLAMATION RESERVE ACT OF 1983, AND S.1006, INTRODUCED BY SENATOR SPECTER, TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO REPEAL THE 15 PERCENT REDUCTION IN PERCENTAGE DEPLETION FOR COAL AND IRON ORE SCHEDULED TO BECOME EFFECTIVE DECEMBER 31, 1983.

BOTH OF THESE MEASURES, MR. CHAIRMAN, HAVE THE FULL SUPPORT OF MY SENATORS - THE DEMOCRATIC LEADER OF THE SENATE, ROBERT BYRD, AND THE RANKING MINORITY MEMBER OF THE ENVIRONMENT AND PUBLIC WORKS COMMITTEE, JENNINGS RANDOLPH. MARC'S MEMBERSHIP APPRECIATES THE RECOGNITION OF THE NEED FOR LEGISLATIVE ACTION ON THESE ISSUES BY YOURSELF AND OTHERS, MR. CHAIRMAN, THROUGH THE SCHEDULING OF THESE HEARINGS AND INTRODUCTION OF LEGISLATION.

COMPREHENSIVE MINING RECLAMATION RESERVE ACT

S.237 WOULD CODIFY THE EXISTING JUDICIALLY RECOGNIZED RIGHT OF A SURFACE COAL OPERATOR WHO USES THE ACCRUAL METHOD OF ACCOUNTING TO DEDUCT THE COST OF RECLAMATION IN THE TAXABLE YEAR IN WHICH THE LIABILITY ARISES. THE EXISTING LEGAL RIGHT OF A TAXPAYER TO ELECT SUCH TAX TREATMENT WAS RECOGNIZED MOST RECENTLY IN A UNANIMOUS

DECISION OF THE U.S. TAX COURT IN DECEMBER, 1981. IN OHIO RIVER COLLIERIES COMPANY V. COMMISSIONER, 77 T.C. No. 103, DECEMBER 31, 1981, THE TAX COURT, IN APPLYING APPLICABLE LAW AND REGULATIONS,[1] HELD THAT IF ALL THE EVENTS HAD OCCURRED THAT DETERMINED THE FACT OF THE LIABILITY AND THE AMOUNT OF THE LIABILITY WAS DETERMINED WITH REASONABLE ACCURACY, THE TAXPAYER MAY DEDUCT ITS ACCRUED RECLAMATION COSTS IN THE YEAR THE LIABILITY ARISES. THE GOVERNMENT DID NOT FILE AN APPEAL OF THE TAX COURT'S DECISION.

IN LIGHT OF THIS EXISTING LEGAL PRECEDENT, AND DECISIONS IN TWO FEDERAL JUDICIAL CIRCUITS [2] UPHOLDING THE RIGHT OF A TAXPAYER TO TAKE THIS DEDUCTION, ONE MAY WONDER WHY IT IS NECESSARY TO ENACT THIS LEGISLATION. THE REASON IS, IN SPITE OF A CLEAR HOLDING BY THE NATION'S PRIMARY TAX TRIBUNAL, AND TWO FEDERAL CIRCUIT COURTS, THE TREASURY DEPARTMENT AND THE INTERNAL REVENUE SERVICE CONTINUE TO CONTEST [3] THE LEGAL RIGHT OF A SURFACE COAL OPERATOR TO TAKE THIS DEDUCTION IN THE YEAR THE LIABILITY ARISES. MR. TONY GENTILE, THE PRESIDENT OF OHIO RIVER COLLIERIES COMPANY, THE PETITIONER IN THE TAX COURT DECISION, WHO TESTIFIED BEFORE THIS SUBCOMMITTEE ON BEHALF OF MARC LAST DECEMBER, INCURRED SUBSTANTIAL COSTS [4]: IN LEGAL FEES, IN THE ALLOCATION OF EMPLOYEE TIME, AND IN LOST USE OF THE AMOUNT OF THE DISPUTED DEDUCTION FOR SEVERAL YEARS IN ESTABLISHING HIS LEGAL RIGHT TO THE DEDUCTION. SIMILAR UNNECESSARY COSTS WILL CONTINUE TO BE INCURRED BY COAL OPERATORS AND THE GOVERNMENT, IN CONTESTING THE DEDUCTION, IF THIS LEGISLATION IS NOT ENACTED.

THESE COSTS ARE PARTICULARLY ONEROUS FOR SMALLER OPERATORS WHO MOST OFTEN DO NOT HAVE IN-HOUSE LEGAL AND ACCOUNTING PERSONNEL BUT MUST CONTRACT OUT FOR SUCH SERVICES. MOST SMALLER OPERATORS SELL

THIS COAL IN THE HIGHLY PRICE COMPETITIVE "SPOT MARKET" FOR COAL; NOT UNDER LONG TERM CONTRACTS. AS A CONSEQUENCE, THESE UNNECESSARY COSTS, WHICH MUST BE PAID OUT OF NET OPERATING REVENUES, RESULT IN DECREASED INCOME OR, QUITE OFTEN, A LOSS. MANY LONG TERM CONTRACTS, GENERALLY HELD BY ONLY LARGER COAL OPERATORS, OFTEN PROVIDE FOR A PASS THROUGH OF SUCH ADDITIONAL COSTS. SUCH COST RECOUPMENT MECHANISMS ARE NOT COMMONLY AVAILABLE TO SMALLER OPERATORS.

ABSENT ENACTMENT OF THIS LEGISLATION, COAL PRODUCERS WILL CONTINUE TO BE FORCED TO INCUR THESE EXPENSES AND THE ACCOMPANYING AGGRAVATION TO TAKE A DEDUCTION CLEARLY ALLOWED UNDER LAW. ALTHOUGH THE TREASURY DEPARTMENT HAS BEEN REQUESTED TO REVISE ITS POLICY 5/ TO MAKE IT CONSISTENT WITH JUDICIAL INTERPRETATIONS; TREASURY HAS GIVEN NO INDICATION THAT THIS POLICY WILL BE MODIFIED. 6/ AS A CONSEQUENCE, UNNECESSARY COSTS WILL CONTINUE TO BE INCURRED BY BOTH COAL OPERATORS AND THE GOVERNMENT.

WITH RESPECT TO THE PROVISIONS OF YOUR BILL, MR. CHAIRMAN, I SUBMIT THE FOLLOWING POINTS FOR YOUR CONSIDERATION.

AS MENTIONED EARLIER, THE QUESTION OF THE ACCRUAL AND DEDUCTION OF RECLAMATION EXPENSES IS TWOFOLD. FIRST, THE FACT OF THE LIABILITY TO RECLAIM THE LAND MUST BE FIXED. THE OPINION OF THE TAX COURT IN THE OHIO RIVER COLLIERIES COMPANY V. COMMISSIONER CLEARLY CONCLUDES THAT ALL THE EVENTS ESTABLISHING THE FACT OF THE LIABILITY TO RECLAIM THE LAND ARE FIXED ONCE THE LAND IS DISTURBED. THE REQUIREMENTS OF THE FEDERAL SURFACE MINING CONTROL AND RECLAMATION ACT OF 1977 (SMCRA) IMPOSE A FIXED LIABILITY WHICH MUST BE SECURED BY A BOND. SEVERAL

STATES HAVE HAD A SIMILAR REQUIREMENT FOR A LONGER PERIOD. IN MY STATE, WEST VIRGINIA, THE LIABILITY HAS BEEN IN PLACE SINCE THE 1960s. YOUR LEGISLATION WOULD STATUTORILY RECOGNIZE THE FACT OF THE LIABILITY.

SECOND, THE AMOUNT OF THE LIABILITY MUST BE DETERMINED WITH REASONABLE ACCURACY. IN THE OHIO RIVER COLLIERIES CASE THE IRS STIPULATED THE REASONABLENESS OF THE RECLAMATION ESTIMATE. IT IS UNLIKELY THAT SUCH STIPULATIONS WILL BE REGULARLY MADE. TO AVOID UNNECESSARY LITIGATION AND REDUCE ADMINISTRATIVE BURDENS ON THE IRS, OPERATORS, AND THE JUDICIAL SYSTEM, I WOULD RECOMMEND THAT EITHER THE LEGISLATION INCORPORATE A DEFINITION OF "REASONABLE" OR THAT GUIDANCE BE PROVIDED IN THE LEGISLATIVE HISTORY. FOR EXAMPLE, LANGUAGE WHICH PROVIDED THAT THE ESTIMATED EXPENSES OF SURFACE MINING LAND RECLAMATION WOULD BE DEEMED REASONABLE IF MADE IN ACCORDANCE WITH CURRENT MINING, INDUSTRIAL ENGINEERING, AND ACCOUNTING PRACTICES WOULD PROVIDE GUIDANCE AND HELP REDUCE THE ADMINISTRATIVE BURDEN ON ALL PARTIES.

SMCRA FACILITATES SUCH A DEFINITION. IT PROVIDES THAT ALL PERSONS WHO ENGAGE IN SURFACE COAL MINING MUST OBTAIN A PERMIT PRIOR TO COMMENCEMENT OF MINING OPERATIONS. PERMIT APPLICATIONS MUST CONTAIN A RECLAMATION PLAN WHICH, AMONG OTHER THINGS, OUTLINES THE METHOD TO BE USED AS WELL AS THE COSTS INVOLVED IN RECLAIMING LAND ALTERED BY COAL MINING ACTIVITIES. A PERMIT IS NOT GRANTED UNTIL OSM OR THE STATE REGULATORY AUTHORITY APPROVES THE RECLAMATION PLAN. A PERFORMANCE BOND, SUFFICIENT TO INSURE THE COMPLETION OF THE RECLAMATION PLAN SHOULD THE OPERATOR NOT FULFILL ITS STATUTORY DUTY, MUST BE SECURED BY THE COAL OPERATOR TO OBTAIN A PERMIT.

THIS RECLAMATION PLAN, REQUIRED TO BE SUBMITTED BY SMCRA, PROVIDES A FIRM AND RELIABLE BASIS FOR ESTIMATING FUTURE RECLAMATION COSTS. ANY MOTIVATION ON THE PART OF COAL OPERATORS TO TAKE EXCESSIVE RECLAMATION COST DEDUCTIONS ON THE BASIS OF INFLATED ESTIMATES IN THE RECLAMATION PLAN IS TEMPERED BY THE CONSIDERABLE COST OF ACQUIRING A PERFORMANCE BOND FOR THE PROJECTED RECLAMATION EXPENSE AND THE SURETY INDUSTRY'S REQUIREMENT TO PLEDGE COLLATERAL EQUAL TO THE AMOUNT OF THE BOND.

MR. CHAIRMAN, THE ABSENCE OF GUIDANCE FOR APPLYING THE TERM "REASONABLE" MAY WELL FRUSTRATE THE INTENT OF YOUR LEGISLATION BY PROMOTING LITIGATION AND ADMINISTRATIVE UNCERTAINTY. MARC ENCOURAGES YOU TO INCORPORATE A DEFINITION.

AN ADDITIONAL POINT I WISH TO HIGHLIGHT, MR. CHAIRMAN, IS THAT YOUR BILL, AS S.1307, THE MINING RECLAMATION RESERVE ACT OF 1983, INTRODUCED ON MAY 18 BY SENATOR SPECTER, RECOGNIZES THE NEED TO PROVIDE THE SAME TAX TREATMENT FOR CASH BASIS TAXPAYERS WHO MAY CHOOSE TO SET UP A RESERVE ACCOUNT TO MEET FUTURE RECLAMATION LIABILITY. THIS IS AN IMPORTANT ISSUE FOR MANY SMALLER COAL OPERATORS AND, AS A MATTER OF EQUITY, SHOULD BE PROVIDED FOR UNDER APPLICABLE LAW.

WITH RESPECT TO YOUR LEGISLATION, MR. CHAIRMAN, I WISH TO UNDERSCORE TWO POINTS.

FIRST, YOUR LEGISLATION DOES NOT CREATE NEW LAW; IT CODIFIES EXISTING LAW. IT WILL PROVIDE SIGNIFICANT RELIEF FROM UNNECESSARY LEGAL AND ANCILLARY EXPENSES FOR SURFACE COAL OPERATORS, THE IRS, AND

THE COURTS. IT WILL NOT OPEN A DOOR FOR OTHER TAXPAYERS TO CLAIM SIMILAR DEDUCTIONS, SINCE, IN THE CASE OF COAL MINE OPERATORS, THERE IS A SPECIFIC FIXED LIABILITY MANDATED UNDER FEDERAL AND STATE LAW WHICH IS SECURED BY A PERFORMANCE BOND ESTABLISHED BY THE REGULATORY AUTHORITY.

SECOND, ENACTMENT OF THIS LEGISLATION WILL RELIEVE A SIGNIFICANT BURDEN ON A SUBSTANTIAL NUMBER OF COAL OPERATORS WHO ARE STRUGGLING TO SURVIVE UNDER CURRENT ECONOMIC CONDITIONS AND HELP TO ASSURE THAT THE UNITED STATES WILL CONTINUE TO HAVE A HIGHLY COMPETITIVE AND EFFICIENT COAL INDUSTRY.

PERCENTAGE DEPLETION REDUCTION

THIS PAST YEAR, IN ENACTING THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 (TEFRA), THE CONGRESS REDUCED THE DEPLETION ALLOWANCE FOR COAL AND IRON ORE FROM 10.0 PERCENT TO 8.5 PERCENT. THIS DISPARATE TREATMENT OF THESE EXTRACTIVE COMMODITIES WAS INEQUITABLE AND UNFAIR PUBLIC POLICY. LACKING A BETTER TERM, THE CONGRESS CHOSE TO KICK AN INDUSTRY WHILE IT WAS DOWN. TO INCREASE THE TAX INCIDENCE OF A SEVERELY DEPRESSED INDUSTRY IN THE MIDDLE OF AN ECONOMIC RECESSION DEFIES COMPREHENSION.

THROUGH THE EFFORTS OF SENATOR SPECTER, THE SPONSOR OF S.1006, THE EFFECTIVE DATE OF THE REDUCTION WAS DELAYED UNTIL DECEMBER 31,1983. AS A CONSEQUENCE, THE CONGRESS HAS AN OPPORTUNITY TO RIGHT THIS WRONG THIS YEAR BY ENACTING S.1006. THE MEMBERSHIP OF MARC STRONGLY SUPPORTS SUCH REMEDIAL ACTION.

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WHEN ONE VIEWS THE MAMMOTH BUDGET OF THE UNITED STATES, THE DOLLAR IMPACT OF THE SCHEDULED REDUCTION IN THE PERCENTAGE DEPLETION ALLOWANCE APPEARS TO BE TRIVIAL. HOWEVER, FOR A COAL COMPANY STRUGGLING TO SURVIVE IN THIS DIFFICULT ECONOMIC PERIOD, THE IMPACT OF THE REDUCTION WILL BE SUBSTANTIAL. THE REDUCTION WILL FURTHER ERODE THE MARGINAL PROFITABILITY OF MANY SMALLER PRODUCERS AND FORCE THEM TO RELY MORE HEAVILY UPON THE DEBT FINANCING FOR CONTINUED OPERATIONS.

COAL CONSUMPTION IN 1982 DECREASED APPROXIMATELY 30 MILLION TONS FROM 1981 LEVELS AND FIGURES FOR CONSUMPTION FOR THE FIRST TWO MONTHS OF 1983 REFLECT A SEVEN PERCENT DECREASE FROM THE CORRESPONDING PERIOD OF 1982. WITH UTILITY STOCKPILES AT RECORD HIGH LEVELS AND COAL PRODUCTION ESTIMATED TO EXCEED PRODUCTION BY 8 TO 12 PERCENT FOR THE FORSEEABLE FUTURE, COAL PRICES WILL CONTINUE TO BE SQUEEZED AND THE MARGINAL PROFITABILITY OF MANY PRODUCERS WILL CONTINUE TO BE JEOPARDIZED.

THE AMERICAN CONSUMER IS THE DIRECT BENEFICIARY OF THE HIGHLY COMPETITIVE COAL INDUSTRY. WHILE THE 15 PERCENT REDUCTION IN THE PERCENTAGE DEPLETION ALLOWANCE WILL NOT, BY ITSELF, SUBSTANTIALLY REDUCE COMPETITION IN THE INDUSTRY, IT WILL, IN CONJUNCTION WITH THE MYRIAD NUMBER OF SPECIAL TAXES AND REGULATORY REQUIREMENTS ENACTED OVER THE PAST 10 YEARS, CONTRIBUTE TO REDUCED COMPETITION AND THE ELIMINATION OF THE BENEFITS RESULTING FROM THAT COMPETITION TO THE AMERICAN PEOPLE BY FORCING THE SMALLER PRODUCER OUT OF THE COAL INDUSTRY.

MARC ENCOURAGES YOU, MR. CHAIRMAN, TO SUPPORT SENATOR SPECTER'S LEGISLATION AND TO ENCOURAGE YOUR COLLEAGUES ON THE FINANCE COMMITTEE TO FAVORABLY CONSIDER IT IN THE NEAR FUTURE.

MARC APPRECIATES THIS OPPORTUNITY TO STATE ITS SUPPORT FOR S.237 AND S.1006 MR. CHAIRMAN. I WOULD BE HAPPY TO RESPOND TO ANY QUESTIONS.

FOOTNOTES

1/ Section 461(a) of the Internal Revenue Code state the general rule that a taxpayer is allowed a deduction in "the taxable year which is the proper taxable year under the method of accounting used in computing taxable income," and the regulations elaborate on this general provision. For accrual basis taxpayers, section 1.461-1(a)(2), provides:

> Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy...While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy.

2/ Harrold v. Commissioner, 192 F. 2d 1002 (4th Cir., 1951) and Denise Coal Co. v. Commissioner, 271 F 2d 930 (3rd Cir., 1959) upheld the right of a taxpayer to deduct accrued expenses for reclamation work mandated by State law.

3/ Internal Revenue Service National Office Technical Advice Memorandum #7831003, April 13, 1978, states in relevant part:

> It is acknowledged that the reasonable estimate doctrine of Harrold has been followed in subsequent coal reclamation decisions. It is also acknowledged that the permissibility of reasonable estimates has not been confined to the Third and the Fourth Circuit or has it been limited to reclamation expense situations. However, the service has not indicated that it will follow either rationale employed or the holdings of any of the above cited decisions.

4/ Ohio River Collieries Company incurred legal expenses of $50,000 and accounting expenses of $20,000 in establishing its right to take the disputed deduction. Although no direct nexus can be drawn, it is ironic that Ohio River Collieries Company has been subject to a full audit which is continuing to date, by the IRS since it prevailed before the Tax Court.

5/ See attached March 11, 1982, letter from Daniel Gerkin, President of MARC, to the Honorable Donald Regan, Secretary of the Treasury.

6/ See attached May 13, 1982, response to March 11, 1982 letter from Mr. William McKee, Tax Legislative Counsel, Department of the Treasury.

7/ The most recent Department of Energy statistics indicate that since 1977 the number of small surface coal mines in the United States has declined by 87 percent, from 2918 in 1977 to 1426 at the close of 1980. A small mine is defined as a mine that produces less than 100,000 tons annually.

Mining and Reclamation Council of America

Suite 525 • 1575 Eye Street, N.W. • Washington, D.C. 20005 • (202) 789-0220

TONY GENTILE
Chairman of the Board

DANIEL R. GERKIN
President

March 11, 1982

The Honorable Donald T. Regan
Secretary of the Treasury
Main Treasury Bldg., Room 3330
Washington, D.C. 20220

Dear Secretary Regan:

This past December 31, 1981 the United States Tax Court, in a unanimous decision, held that an accrual basis surface coal operator may deduct accrued reclamation costs for a taxable year when all the events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy. The court, in this case, Ohio River Collieries Company v. Commissioner of Internal Revenue, 77 T.C. No.103, rejected the position of the Commissioner that such liability can only be deducted in the taxable year in which the expense occurred.

For accrual basis taxpayers this decision is consistent with provisions of legislation which is currently pending before the Congress. H.R.4815, introduced by Representatives Don Bailey and Austin Murphy and S.1911, introduced by Senators Arlen Specter, and Robert C. Byrd both titled the Mining Reclamation Reserve Act of 1981, would provide for the establishment of reserves for mining land reclamation and for the deduction of amounts added to such reserves. This legislation recognizes the fixed liability of surface coal operators, under applicable federal and state laws, to reclaim disturbed land following the completion of mining activity.

The membership of the Mining and Reclamation Council of America (MARC) supports this legislation and is committed to gaining its approval by the Congress. However while this legislation is pending, needless litigation on this issue will likely occur as a result of the Commissioner's position which is contrary to the Tax Court's decision. As a consequence, we request that the Treasury Department take appropriate action to establish the Tax Court's decision as the federal government's position on this issue. Similarly, we urge you to support the Mining Reclamation Reserve Act and to communicate such to the appropriate committees in the Congress.

Your attention to this matter is appreciated.

Sincerely,

Daniel R. Gerkin
President

CC: Reps. Bailey, Murphy
Sens. Specter, Byrd

OFFICE OF THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

MAY 13 1982

Dear Mr. Gerkin:

This is in response to your letter of March 11, 1982 concerning H.R. 4815 relating to tax accounting for surface mining reclamation expenses.

H.R. 4815 would permit surface mine operators who use an accrual method of accounting to deduct reclamation costs at the time the surface land is disturbed and would permit cash basis taxpayers to deduct additions to a reserve for reclamation costs.

The issues involved in H.R. 4815, principally the proper time to accrue estimated expenses for services to be performed in the future, have arisen in many different contexts. The members of my staff responsible for tax accounting issues are currently studying H.R. 4815 and its effects on this area of the law. It would thus be premature to comment on Treasury's position at this time.

Thank you for bringing your concerns to our attention.

Sincerely,

William S. McKee
Tax Legislative Counsel

Mr. Daniel R. Gerkin
President
Mining and Reclamation Council of America
Suite 525
1575 Eye Street, N.W.
Washington, D.C. 20005

Senator WALLOP. Thank you very much, Mr. Keating.
Mr. Nicholls.

STATEMENT OF JOSEPH E. NICHOLLS, JR., SENIOR VICE PRESIDENT, DRUMMOND COAL CO., ON BEHALF OF THE TAX COMMITTEE OF THE NATIONAL COAL ASSOCIATION

Mr. NICHOLLS. Thank you.

My name is Joseph E. Nicholls and I am a member of the NCA Tax Committee and senior vice president of Drummond Coal. I appreciate the opportunity to express our views on S. 237 and 1006, both bills being supported by the National Coal Association.

First on the accrued reclamation issue, I think it is rather interesting to note that the coal industry has dropped the legal arguments on the all-events test and moved to the practical side. I believe we have the case law and I believe all we are asking is for a codification of existing law and some relief from the special tax accounting and the administrative costs.

We do believe, though, that there are two areas that warrant some attention in the way of a modification, and I think Treasury began to attack it today, and this is the concept of what constitutes a reasonable estimate. We would like to have the bill amended to effectively say that generally accepted current accounting, mining, and industrial engineering practices would be an acceptable basis for a reasonable estimation.

The other thing is, surface mining is as visible as an elephant in the monkey pen, but underground mining has the same problems and is subject to the same regulations as the surface miner around their mines and the property overlying the mine shafts proper. It would be very helpful to have the bill amended to make it quite clear that it was intended to cover reclamation applicable to underground mining. My understanding from some people in our own company and people at NCA, the estimation techniques are reasonably accruate and the liability is basically the same.

That is really about all I have to say on the reclamation bill.

On the percentage depletion bill, obviously we support that. We feel basically it is an equity argument and a capital formation argument. We are not quite sure why we were singled out, coal and iron ore were singled out, to be the only ones affected.

Coal is an industry that last year operated at four-fifths of its capacity and this year is running at about two-thirds of its capacity. The last reading we had is unemployment is about 32 percent, and we have another economic penalty coming at us a reduction in percentage depletion.

On the equity side, as Don Bailey mentioned, this is a capital intensive industry. In addition, we tend to be a long-term contract-oriented industry and the economics of negotiating those contracts definitely take into account the tax law. It is terribly hard to do planning when you are subject to a yo-yo effect in your taxation, your basic taxation policies.

My company entered into a long-term contract and started a related construction project in 1978 which was finished last year, about a 4-year capital developments cycle. It cost us $150 million in capital, which represents 75 percent of our now equity. A reduction

in percentage depletion has a major impact upon what considered an acceptable ROI at date we entered the contract.

The industry is facing a requirement for $48 billion of new capital between now and 1990. It is estimated that that will have to double by the year 2000. The reduction in the depletion certainly will not help us to compete in the capital markets for funds.

It does not really make a lot of economic sense to reduce the financial health of an industry when it may be our only viable alternate source of energy in the near term.

I would like to thank you for the opportunity to testify for the National Coal Association. If there are any questions, I would be happy to answer them.

[The prepared statement of Mr. Nicholls follows:]

Statement of Joseph E. Nicholls, Jr.

on

Behalf of

The National Coal Association

My name is Joseph E. Nicholls, Jr.. I am a member of the Tax Committee of the National Coal Association, and Senior Vice President of Drummond Coal Company. We appreciate this opportunity to express our views with respect to the accrual of reclamation reserves and the preservation of our full 10 percent depletion allowance.

The membership of the National Coal Association (NCA) consists primarily of producing coal companies, whose operations comprise over half of the production in the United States. In addition, we number in our membership equipment manufacturers, railroads, coal exporters, consultants, and other coal related industries. I will discuss first the accrual matter and close with our comments on depletion.

S.237

NCA supports the Comprehensive Mining Reclamation Act of 1983 (S.237) introduced by Senator Wallop. For many years the coal industry has maintained that the accrual of costs for reclamation is proper under the Internal Revenue Code (I.R.C.). Two Federal Circuit Courts of Appeals have so ruled. In 1981, the U.S. Tax Court reversed its previous position and held that the accrued reclamation costs are deductible for income tax purposes. However, the tax treatment of reclamation costs appears to be one of those issues that will not be a settled issue between the coal industry and Internal Revenue Service (IRS) unless specific legislation is passed.

The IRS and members of NCA have long been familiar with pertinent court cases which we believe supports the coal industry's position on the deductibility of accrued reclamation costs. However, the coal industry continues to incur legal, accounting, engineering, and incremental in-house costs to counter IRS adjustments disallowing the accrual of reclamation costs. Last September, my company received a notice from the

IRS disallowing our reclamation costs deduction. Not only will my company now incur additional costs but so will the government, i.e., IRS, courts, etc. This is an inexcusable waste of economic resources needed to capitalize industry and operate our government.

ISSUES

My testimony will address whether costs for reclamation meet the requirements of I.R.C. Section 461(a) as interpreted by Section 1.461-1(a)(2) of the Income Tax Regulations in the year the land is disturbed and are these costs therefore, deductible in that year by an accrual basis taxpayer ("Current Law") and the proposed act, S.237.

CURRENT LAW

Facts:

Coal mine operators are mandated by both federal and state law to restore land that is disturbed by the mining process. The Federal Surface Mining Control and Reclamation Act of 1977, Public Law 95-87, (hereinafter referred to as the Federal Reclamation Act of 1977) provides that prior to receiving a mining permit each mine operator must submit and receive approval of a reclamation plan which complies with both federal and state law. Pursuant to Section 509(a) of the Federal Reclamation Act of 1977 each mine operator is required to furnish a bond in an amount "sufficient to assure the completion of the reclamation plan if the work had to be performed by the regulatory authority in the event of forfeiture." Note however, that while bonding figures are reasonably accurate, they do not reflect the actual costs and should not be used as a standard for accrual purposes. In addition, this federal statute requires that the states impose criminal sanctions including jail sentences of up to one year for willful failure to meet statutory reclamation requirements.

A mine operator's obligation to reclaim the land becomes fixed immediately when the land is disturbed. Simultaneously, with the removal of dirt from the seam of coal, the mine operator incurs the obligation for reclaiming the land disturbed by removal of the dirt. For book purposes a mine operator must match the expense of reclamation to the disturbance of the land and the related liability to reclaim the land. Therefore, in conjunction with the creation of the obligation for reclamation the mine operator accrues on his books the costs which will be required in order to reclaim the land which has been disturbed as a result of mining operations. Not only direct reclamation costs, but all mine closing expenses should be permitted to be accrued. These include work required by federal and state law, such as removal of buildings and equipment, the disposal of refuse and the restoration of roads. Also included are the maintenance of air and water quality. With respect to maintenance of water quality, the cost of the function could continue on for years after the mine is closed.

In addition to accounting requirements, several other factors have required the development of reliable and precise engineering techniques to ascertain the costs which will be incurred to reclaim disturbed land. Escalation clauses of many long-term sales contracts permit adjustments in the sales price of coal for increase in accrued reclamation cost. Such increases directly impact cash flow to the mine operator and are subject to intense audit by the coal purchaser. Additionally, as previously mentioned, the taxpayer's estimates of reclamation costs are also used to determine the amount of reclamation bonds which are required to be posted. Finally, mining operators, as prudent business persons, must know what the actual total cost of mining a ton of coal on a current basis is, including reclaiming the land from which the coal was mined, in order to compete in today's highly competitive environment.

Law:

Section 1.461.1(a)(2) of the Regulations provides a two part test, which is to be used by an accrual basis taxpayer in determining the timing of a deduction. This section of the regulations provides that a taxpayer shall deduct an expense in the taxable year in which:

1. All events have occurred which determine the fact of the liability; and

2. The amount of the liability can be determined with reasonable accuracy.

We believe that accrued reclamation costs meets both of these tests for the taxable years in which the land to be reclaimed is disturbed. For purposes of discussion we will address each of these tests separately.

It is our contention that the first of these tests is met each time the land is disturbed and that it is met immediately when the land is disturbed. Pursuant to the requirements of both federal and state law a coal mine operator has a requirement to reclaim all land disturbed in the mining process and that requirement occurs when the land is disturbed.

The U.S. Tax Court in Ohio River Collieries Co. v. Commissioner, 77 TC No. 103, 12-31-81, reversed its earlier position in Harrold v. Commissioiner, 16 TC 134 (1951), revd. 192 F.2nd 1002 (4th Cir. 1951) and is now in concert with the Circuit Courts in regard to satisfaction of the all events test for reclamation liabilities. In Ohio River Collieries, the taxpayer accrued on its books and claimed as a deduction for federal income tax purposes the estimated cost of reclamation work required by Ohio law but not accomplished by the end of the taxable year. The government concluded that the taxpayer's statutory duty to reclaim did not create any liability to pay and that therefore

the estimated costs was not deductible. The court, citing the Ohio law requirement for a strip miner to estimate his reclamation cost and post a surety bond to cover it, held that once strip mining occurs the liability becomes certain and thus the all events test is satisfied.

Previously the 4th Circuit, upon appeal of Harrold, also held that all events necessary to determined the liability occurred in the year that the statutory obligation to reclaim was imposed on the operator. The court was presented with the situation where the taxpayer was required by the law of the State of West Virginia to reclaim the land where the taxpayer had stripmined. The taxpayer deducted the cost to reclaim the land in the year the land had been mined (1945) and the government contended that expense of reclamation work was deductible in 1946 the year the reclamation was performed. In deciding that the reclamation was properly deductible in 1945 (the year the mine was stripped) the Fourth Circuit adopted the approach which has since been widely followed by the courts. It held that the reclamation activity itself was not a prerequisite for deductibility. The court found that "all the facts have occurred which determined that the taxpayer has incurred a liability in the tax year" (in which the operator became obligated by statute to reclaim the disturbed land). The court went on to say that to permit a deduction in the year in which the statutory obligation attached to the mine operators "allocates to each year the proper income and expense and prevents distortion of the taxpayers financial condition in the tax year."

Denise Coal Co. v. Commissioner. 271 F. 2d930 (3rd Cir. 1959) also addressed the question of the year of the deduction for accrued reclamation expenses. In Denise the taxpayer was required by Pennsylvania law to reclaim land which it had stripmined. The taxpayer estimated the costs of reclaiming the land on which it mined and deducted the cost in 1948 even though the actual reclamation activity was not completed until 1956. The court citing Harrold approved the deductions in the year the mine operator became

obligated by statute to reclaim the land. In so holding for the taxpayer the court stated that the "Pennsylvania statute imposes a fixed and definite obligation."

The conclusion that the liability for reclamation was fixed in the year that the statutory obligation is imposed was also accepted in Commissioner v. Gregory Run Coal Co. 212F.2d52 (4th Cir. 1954), Cert. denied 348 U.S. 828 (9154) and Patsch v. Commissioner, 208F2d532 (3rd Cir. 1954). Both of these cases involved the question of the proper year of deduction for reclamation expenses accrued by coal mine operators. In both these cases, however, the deduction for the reclamation was denied because taxpayers based the estimate of the amount of the liability on arbitrary and untested rules of thumb and therefore failed to met the "reasonable accurate", test prescribed in part two of Section 1.461-1(a)(2) of the Regulations.

Prior to Ohio River Collieries, the Tax Court had already indicated its approval of the reasoning of the Harrold and Denise decisions in World Airway, Inc. and World Air Center, Inc., Petitioners v. Commissioner of Internal Revenue, Respondent, 62 TC 786 (1974). The Tax Court in World Airways, denied the taxpayer a deduction for an accrual to overhaul aircraft engines at some time in the future. In denying the deduction the Tax Court distinguished World Airways, from Harrold, and Denise, saying that in the Harrold, and Denise, cases the "accruals were allowed because in the taxable years in which the deductions were taken, there had occurred all the operative facts giving rise to the obligation to restore the stripped land."

The position of the court in Harrold, that it is not necessary to actually perform the work in order to be permitted a deduction has been adopted in a number of other decisions outside the area of reclamation as follows:

1. In Scheussler v. Commissioner, 230F.2d722, (5th Cir. 1956), the Fifth Circuit permitted an accrual method taxpayer to deduct in the year of sale the estimated cost of turning on furnaces each year for a period of five years. This case involved a situation where the taxpayer incurred the

obligation to turn the furnace off and on for a period of five years at the time the furnaces were sold.

2. In Pacific Grape Products Co. v. Commissioner, 219F.2d862 (9th Cir. 1955), the Ninth Circuit allowed a seller of food products to deduct in the year of sale, the cost of packaging, and shipping products which had been sold even though the shipping and packaging had not been performed.

3. Gillis v. United States, 402F.2d501 (5th Cir. 1986) involved a situation where as a condition of being permitted to purchase cotton at an artificially low price from a government agency, the taxpayer was required to export an identical amount of cotton at a price below the market value. The court decided that the taxpayer correctly recognized the loss, which would be incurred on the sale of the cotton, in the same years the gain on the purchase was recognized.

The current position of the Internal Revenue Service is apparently set out in the National Office Technical Advice Memorandum #7831003. The Tax Court in Ohio River Collieries, has now clearly stated its position that once strip mining occurs the liability to reclaim, pursuant to applicable law, is fixed. Furthermore, there is only one non Tax Court decision since Harrold, cited in this Technical Advice as support for the position that accrued reclamation does not represent fixed liability. The sole case is Schlude v. Commissioner, 372 U.S. 128 (1963); which involves prepaid income, and the question of the year of inclusion of prepaid income is easily distinguishable from the question of the year of deduction of accrued expenses.

The second part of the test under Section 1.461-1(a)(2) of the Regulations is that the amount of the liability must be determined with reasonable accuracy. We submit that, based on extensive experience and by using generally accepted engineering principles, the coal mine operators are able to compute the amount of accrued

reclamation expense with a relatively high degree of accuracy. To avoid any confusion as to how to define reasonable accuracy we suggest that it be made clear that the estimate shall be deemed reasonable if it is based on current accounting, mining, or industrial engineering practices.

The Fourth Circuit, in Harrold, stated that a liability which meets the all events test is deductible if the amount of the liability "although not definitely ascertained is susceptible of estimate with reasonable accuracy in the tax year." The approach of permitting a reasonable estimate, as opposed to requiring the reclamation activity be complete and the actual cost per unit be known, is the interpretation virtually all courts have applied to the phrase "determined with reasonable accuracy" as it is used in Section 1.461-1(a)(2) of the Regulations. We submit, therefore that the taxpayers have determined the amount of the liability for reclamation with reasonable accuracy.

Conclusion:

Based on the authority, the taxpayers believe that the liability for reclaiming the acres disturbed as of the end of each year in question is both fixed and determined with reasonable accuracy.

While we believe the existing body of law, including two Federal Court of Appeals cases and the recent U.S. Tax Court case, is clear, we do not believe the IRS is ready to accept it as the law. The IRS' National Office Technical Advise Memorandum (#7831003) states:

> "it is acknowledged that the reasonable estimate doctrine of Harrold has been followed in subsequent coal reclamation decisions. It is also acknowledged that the permissibility of reasonable estimates has not been confined to the third and the fourth circuit or has it been limited to

reclamation expenses situations. However, the service has not indicated that it will follow either the rationale employed or the holdings of any of the above cited decisions."

Based on the IRS' actions to date, it appears their strategy is to continue disallowing accrued reclamation deductions hoping to find a friendly court. This process has been and will continue to be expensive to both the coal industry and the Government. This is documented in a letter the National Coal Association received from the IRS earlier in the year, a copy of which is attached to this statement.

We believe the course chosen by the IRS is not only ill-advised but very expensive to the Government. Consider that gross accrued reclamation costs adjustment also have offsetting adjustments:

- Coal inventory value would be reduced.
- Allowed percentage depletion deductions would increase and,
- Gross sales amounts of certain of our members would be reduced.
- Taxpayers expenses increases to legally challenge the reclamation issue.

In the case of my company, the IRS has disallowed a cumulative $9.5 million for accrued reclamation costs. We are at various stages of protesting the disallowances. My best estimate of our offsets would reduce the IRS' cumulative disallowances to $5.5 to $6.5 million (60% to 70%) should it prevail in its position. I think it is worth noting that the $9.5 million represents only 5 to 6 months of actual reclamation cost expenditures (cash basis) and reclamation costs, in the aggregrate, are over 6% of our production costs.

There is also an equity factor that should be considered when dealing with reclamation. The minimum period in which cash expenditures are incurred for

reclamation activities after the closure of a mine is five years. Existing tax law provides for a carry-back of net operating losses to the third preceeding year. The probability of having taxable income from a closed operation is nil. Therefore, coal companies will permanently lose some portion of their reclamation costs as a tax deductible expense if a cash basis accounting is required.

NCA members believe that the existing body of law supports the deduction of reclamation expenses on the accrual basis, and if we were willing to wait for the legal conflicts with the IRS to be resolved in either the Federal Courts or the Tax Court, the coal industry would continue to prevail in its position. However, the ever mounting non-productive costs to the coal industry and the Government, and the interaction with other areas of coal company operations such as finance brought about by the uncertaintity has led us to conclude that legislative action is necessary.

May I suggest one small item that we think would improve the bill by making it equitable as between strip and deep mining. S.237 deals with land reclamation requied as a result of the extraction of minerals by surface mining activities. The Surface Mining Control and Reclamation Act of 1977 also requies restoration ofthe surface land which is disrupted as a result of underground coal mining. There is really no practical difference between the two types of expenses and we believe they should be covered in any legislation dealing with the problem.

S.1006

This bill, introduced by Senator Specter, would correct an inequity which was created by the Tax Equity and Fiscal Responsibility Act of 1982. At that time the Senate was considering a 15 percent reduction in the percentage depletion deduction for all minerals. Only coal and iron ore fell victims to the cut. An amendment by Senator Specter delayed that reduction until 1984. The purpose of the Amendment was to assist the economic recovery of those two strife-torn industries during 1983.

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Unfortunately, the recovery has not materialized. The coal industry was operating at 80 percent of capacity last year. Today, that figure is down to 67 percent. Unemployment in the coal fields stands at about 32 percent.

Senator Specter's bill would eliminate the scheduled reduction in the depletion deduction for these depressed industries. To initiate what is an increase in taxes for these industries would not only cripple the efforts of coal and iron ore to recover, but would actually curb any recovery activity.

It should be observed that coal's 10 percent depletion allowance is already low compared to other minerals, which receive allowances as high as 22 percent. While all domestic minerals are extremely important to the Nation's welfare, none are any more important to the economy than coal and iron ore -- the two that face a reduction in the depletion deduction at a time they can least afford it.

It has been argued that coal and iron ore already receive the benefits of capital gains treatment on royalties. This thinking is fallacious since you are comparing apples and oranges. The miner does not receive the benefit of capital gains treatment on royalties. He pays the royalty to the landowner to mine the landowner's minerals. Percentage depletion and capital gains treatment of royalties have, over the years, resulted in a delicate balance that should not be disturbed.

The coal industry has been severely impacted by the current worldwide recession. Both domestic and foreign consumption are down. Hundreds of mines are closed and thousands of miners are out of work. Artificially low gas prces, the oil glut, and high transportation costs are making coal less competitive with other fuels. An additional tax burden will only increase the problem. And this new burden will hurt the small producer as well as the large company with many mines, since depletion is figured on a mine-by-mine basis.

There is presently an overcapacity to produce in our industry. This is due primarily to certain restraints placed on the burning of coal which hopefully will be

eased. Notwithstanding this temporary current overcapacity, we are optimistic about the future of the industry; a future that will require huge capital outlays.

By conservative estimates, the coal industry will require at least $48 billion between now and 1990 and over twice that much by the year 2000 to meet capital investment requirements. These amounts stated in current dollars, are inordinately in excess of the current total industry capitalization of almost $15 billion.

While capital costs may vary according to the terrain and the depth of the seam, it is generally accepted in the coal industry that the capital cost to install a new deep mine, exclusive of the cost of coal, is over $100 per ton of annual production. Thus, a medium-sized mine, with a capacity of one million tons a year, represents well over a $100 million capital expenditure by the time it actually begins commercial production. These new mines will mean thousands of more jobs for miners. In terms of capital requirements, approximately $360,000 of investment will be required for each new mining employee.

Production costs are also skyrocketing. Total industry production costs increased over 100 percent during the period 1973 to 1982. The cost of machinery alone was up over 100 percent during that period.

The foregoing discussion on the capital needs of the industry illustrates why it is critically essential to the coal industry to obtain funds of a magnitude never before required.

I stated earlier that there is presently an over-capacity to produce coal in this country. Percentage depletion is limited to 50 percent of the taxable income from the property. This, coupled with the historically low rate of profits in the coal industry, means that very few, if any, existing coal mines can currently take advantage of the full ten percent allowance. In a survey of NCA members, it was found that the actual effective rate of percentage depletion was only four percent. If the reduction is allowed to take effect, that small four percent will be reduced by 15 percent. It may not seem

like much, but the reduction will impact substantially on investment in the new coal mines which we are going to need in the not to distant future. A coal mine is designed to last, on the average, about 20 years, so each year the maintenance of existing demand would require new coal mines equal to about 5 percent of total capacity. When you add to that the greatly increased demands for coal in the years ahead, you can understand that a very large number of mines must be opened. Opening new coal mines takes from 5 to 7 years, and a great deal of capital.

I stated in some detail the capital requirements of the coal industry. Coal must compete in the money market for these funds. Given the high risk nature of coal mining and the low profit margin, any reduction in incentives that would have a current or future adverse impact on profits will further dry up any available venture capital for opening new mines.

It is simply poor economics to penalize the coal and iron ore industries in an action that would probably cost the Federal government money in the long run, given the loss in tax revenues from healthy coal and iron ore industries and the increase in the cost of entitlement programs to asist the unemployed.

Thank you for affording us the opportunity to present our views on these two measures, so vital to the coal industry.

[illegible] States [illegible] Department of the Treasury [illegible]

[illegible]shington, DC 20224

National Coal Association
Attn: Robert F. Stauffer,
Vice President and
General Counsel
1130 Seventeenth Street, NW
Washington, DC 20036

Person to Contact:
David L. Crawford
Telephone Number:
(202) 566-3775
Refer Reply to:
CC:C:C:2:1
Date:
30 APR 1982

Dear Mr. Stauffer:

This is in reply to your letter dated March 16, 1982, that has been forwarded to this office. You have asked us to reverse our position with respect to the treatment of the estimated costs of reclaiming strip-mined land. The reclamation liability you refer to is derived from the Federal Surface Mining Control and Reclamation Act of 1977 which, as stated in your memorandum, provides that prior to receiving a coal mining permit each mine operator must submit and receive approval of a reclamation plan which complies with both federal and state law. Pursuant to section 509(a) of the Federal Reclamation Act of 1977, each mine operator is required to furnish a bond in an amount sufficient to assure the completion of the reclamation plan if the work had to be performed by the regulatory authority in the event of forfeiture.

Your thorough and well-documented memorandum will aid us in a review of the issue of whether an accrual method taxpayer, engaged in the business of strip-mining coal, may deduct the estimated cost of restoring land that is disturbed by the mining process, in the taxable year that the land is disturbed. We are evaluating the cases cited in your memorandum; however, at this time it is premature to conclude whether our position will be to appeal the Tax Court decision in Ohio River Collieries Co., v. Commissioner, 77 T.C. No. 103, dated December 31, 1981. The time for appeal in this case does not expire until June 6, 1982. However, it should be understood that our present position on this issue is set forth in LTR 7831003 and our litigating position in Ohio River Collieries, supra.

Thank you for your fine submission and you can be assured that it will receive full and careful consideration.

Sincerely yours,

John L. Crawford

Chief, Corporation Tax Branch

Senator WALLOP. Thank you, Mr. Nicholls.
Mr. Penoyer.

STATEMENT OF ROBERT PENOYER, CHIEF EXECUTIVE OFFICER, SRP COAL CO., ON BEHALF OF THE PENNSYLVANIA COAL MINING ASSOCIATION

Mr. PENOYER. Mr. Chairman, my name is Bob Penoyer and I am chief executive officer of SRP Coal Co. and I am here to represent the people in the Pennsylvania Coal Mining Association. And our association represents 120 producing members in the Commonwealth of Pennsylvania, and we represent 80 percent of the surface-mined coal produced in the State.

PCMA has long championed the need for an amendment clarifying the relevant provisions of the Internal Revenue Code to allow current deductions for reasonably estimated expenses of surface mining reclamation. The original bills introduced in Congress several years ago had the strong support of our association, and we come here today again in strong support of S. 237.

As I testified before this committee last December, the Pennsylvania surface coal mining industry is in a terrible economic slump because of weak domestic and international coal markets. Many companies, especially the smaller companies mining under 100,000 tons, which are the bulk of the Pennsylvania surface mining industry, are barely able to survive. Every month more of our companies are going out of business. Pennsylvania coalfields are besieged by chronic unemployment and the coal industry is the key economic synergist in these areas.

Any reasonable and sound tax measure which allows surface mining companies such as my own to maximize cash flow by sound accounting principles as included in S. 237 are vital to enable our company and many others to survive.

The rest of the gentlemen in the group have gone over the Ohio River collieries case and I am sure you are aware of the arguments that we can go through on those. Therefore, we support the concept of providing a safe harbor which will eliminate the litigation of what estimates are reasonable.

Section 508 of SMCRA requires any coal operator securing a permit to estimate with reasonable accuracy and engineering precision the proposed reclamation costs as part of our reclamation plan when submitted. Because of the self-enforcing nature of this figure, IRS need not worry about any potential for overestimation or abuse. The coal industry will not seek any unnecessarily large deduction at the expense of incurring larger bonding costs.

Because the reclamation cost figure included in the reclamation plan must be approved by OSM or the State regulatory authority and is the basis of the bond amount, this safe harbor would be self-policing.

We would support the applicability of this deduction to both cash and accrual basis taxpayers, as we read S. 237. In Pennsylvania, like I said, there are many small operators who are on a cash basis accounting method and who provide a vital and effective role in the surface mining industry and who mine under 50,000 tons per year.

The Treasury's arguments that they gave this morning—as an aside, I would not be in business if I had to project my reclamation costs 7 years in advance of my cost, as Mr. McKee was intimating on his $100 and 50 percent. Which reminds me, I would dearly love to be in a 50-percent tax bracket with my company. So his arguments ring rather hollow as far as I am concerned.

In regards to S. 1006, which was introduced on April 7 by Senator Specter, the association wishes to place on record its sincere appreciation for Senator Specter's initiative in that regard. It is typical of the Senator's longstanding support of our industry, and S. 1006 will eliminate the scheduled 15-percent reduction for depletion for coal and iron ore.

This measure is absolutely essential to allow the coal industry in Pennsylvania to struggle back onto its feet.

In conclusion, we hope the committee will support these bills because they provide vital relief for the economically besieged coal industry at a time when weak domestic markets and international markets and increased regulatory costs have cast a very dark cloud over our industry.

Thank you.

[The prepared statement of Mr. Penoyer follows:]

STATEMENT OF ROBERT PENOYER, SRP COAL CO., INC.

Mr. Chairman, members of the committee, my name is Robert Penoyer. I am the chief executive officer of SRP Coal Co., Inc. of Clearfield, Pennsylvania. Appearing with me is Stephen Braverman of the law firm of Dilworth, Paxson, Kalish and Kauffman of Philadelphia. I greatly appreciate the opportunity to appear before this Committee again. I had the privilege to testify before you on December 7 of last year in support of S. 1911 and S. 2642. It is my sincere hope that S. 237 is enacted by the Ninety-Eighth Congress.

SRP Coal Co., Inc., is a surface mining company founded by my father which produces approximately 50,000 tons of bituminous coal annually. I personally have been in the coal business for 35 years starting in the family business in 1948.

I am on the Board of Directors of the Pennsylvania Coal Mining Association and I am a member of its executive committee as well as a regional Vice President of Region 4, a region covering seven coal producing counties including Clearfield County. The Pennsylvania Coal Mining Association has over 160 producing members who produce approximately 60% of the entire surface mining production of Pennsylvania on an annual basis. The Association also has 125 associate companies which provide goods and services to the surface mining coal industry.

PCMA has long championed the need for an amendment clarifying the relevant provisions of the Internal Revenue Code to allow a

current deduction for reasonably estimated expenses of surface mining reclamation.[1] The original bills introduced in Congress several years ago had the strong support of our Association. We come here today again in strong support of S. 237. The major thrust of this bill is to allow the surface mining coal industry, as well as other mineral extractive industries, to match expenses and revenue by allowing current deductions for the fixed liability of future reclamation expenses.

As I testified last December, the Pennsylvania surface coal mining industry is in a terrible economic slump because of weak domestic and international coal markets. Many companies, especially the smaller companies mining under 100,000 tons, which are the bulk of the Pennsylvania surface mining industry, are barely able to survive. Every month, more companies are going out of business. The Pennsylvania coal fields are besieged by chronic unemployment. The coal industry is the key economic synergist in these areas.

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1. Section 461(a) of the Internal Revenue Code states that a taxpayer is allowed a deduction in "the taxable year which is the proper taxable year under the method of accounting used in computing taxable income". The regulations provide in section 1.461-1(a)(2) that:

> Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. ...While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy.

The industry is suffering a severe cash flow crisis in a time of weak markets and significantly escalation regulatory costs. Any reasonable and sound tax measures which allow surface mining companies such as SPR Coal Co., Inc. to maximize cash flow by the sound accounting principals included in S. 237 are vital to enable our company and many others to survive.

We, therefore, support the principals of S. 237 and the sound tax and accounting doctrines it codifies. Last December, the Assistant Secretary for Tax Policy, Mr. John E. Chapoton, objected to S. 1911 and S. 2642 on the grounds that such legislation will reduce revenue. However, in as much as S. 237 codifies existing law as set forth in the decision of the Tax Court in Ohio River Colleries Company, Inc. v. Commissioner[2] there should be no more revenue reduction than would occur without such legislation if taxpayers took full advantage of that decision and prior case law. In that case the Tax Court only further reaffirmed the propriety of current deductions of reasonably estimated fixed liabilities for future reclamation expenses. I must point out that the Ohio River Colleries case was an anomaly - the IRS stipulated to the reasonableness of the reclamation expenses at issue in that case. In fact, the history of litigation over these deductions has been marked by protracted

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2. 77 T.C. 1369 (1981), App. 6/7/82 (USCA 6); App. dismissed.

disputes and litigation over the reasonableness of reclamation expenses for coal companies seeking to take the deduction.[3] The Treasury, in its testimony on S. 1911 and S. 237, only discusses the Ohio River case and takes the position that it was incorrectly decided. Treasury does not mention the Harrold and Denise Coal cases which are discussed in our testimony and which provided a legal foundation for such deductions a number of years prior to the Ohio River decision. In addition, Treasury fails to mention that the Government conceded reasonableness in that case. Although this was perhaps a mistake on the part of the trial attorney, it still reflects a position of the Government that a reasonable estimate can be made prior to the actual expenditure. The Government should not be permitted to argue that a reasonable estimate cannot be made until such time as it concedes that the concession of reasonableness in the Ohio River case was a litigating error. Moreover, any conflicts on the

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3. See Denise Coal Company v. Commissioner 271 F.2d 930 (3d Cir. 1959) and Harrold v. Commissioner 192 F.2d 1002 (4th Cir. 1951) involving coal reclamation costs.

It is doubtful, in our view, that the IRS will again stipulate to the reasonableness of the estimate as it did in the Ohio River case. Even the Tax Court expressed surprise that the government stipulated so much. 77 T.C. 1369 at 1374.

question of reasonableness can be eliminated by the safe harbor provision which we are recommending.

It should be noted that Treasury states that it intends to continue litigating such cases as Ohio River, evidencing a current need for this legislation, notwithstanding three significant court cases going against the Government. These controversies impose unnecessary burdens on the courts, the IRS and the taxpayers because they involve valuation issues. The Tax Court has recently expressed its displeasure with the costly, time consuming adjudication of valuation issues.[4]

We, therefore, support the concept of providing a "safe harbor", which will eliminate the litigation of what estimates are reasonable. This logical safe harbor arises under §508 of the Surface Mining Control and Reclamation Act of 1977, 30 U.S.C. §1258. Section 508 of SMCRA requires any coal operator securing a permit to estimate with reasonable accuracy and engineering precision the proposed reclamation costs as part of the reclamation plan. The figure included in the reclamation plan is then used as the basis for the bond required by §509 of SMCRA, 30 U.S.C. §1259. Because of the self-enforcing nature of this figure, IRS need not worry about any potential for overestimation or abuse. The coal industry will not seek an unnecessary large deduction at the expense of incurring larger bonding costs.

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4. Buffalo Tool & Die Manufacturing Co., Inc., et al v. Commissioner, 74 T.C. 441, 451-52 (1980).

This express recognition of the logical safe harbor is §508 of SMCRA or the appropriate state legislation where the state is the regulatory authority, will eliminate once and for all the protracted litigation and the legal, engineering and accounting costs that arise because of IRS challenges to the reasonable estimate of reclamation expenses. Because the reclamation cost figure included in the reclamation plan must be approved by OSM or the state regulatory authority and is the basis for the bond amount, this safe harbor would be self-policing mechanism.

We also support the applicability of this deduction to both cash and accrual basis taxpayers as we read §237. In Pennsylvania, there are many small operators who are on the cash basis accounting method and who provide a vital and effective role in the surface mining industry who mine under 50,000 tons a year.

With respect to the Treasury's earlier testimony on S. 1911 and 2642, the following points must be made:

Treasury is incorrectly reinterpreting the Ohio River case by stating that the Court permitted the deduction "even though reclamation work had not been started and the taxpayer had no present liability to pay for the performance of such work". I do not agree with this interpretation in light of the fact that in the Ohio River case there was a present liability by virtue of the fact

that mining had commenced, and, under Ohio law, the obligation to reclaim arises when the strip mining commences, the estimate of reclamation costs is filed with the state, and the surety bond is posted. The Court completely rejected the Government's argument that the liability had not yet arisen.

Treasury states that a rule that grants a deduction today for tomorrow's expense overstates the true cost of the expense by failing to take into the account the time value of money. This may be true; however, it is also inherent in the accrual accounting method which is designated to provide deductions for amounts which have not yet been paid. All that is required is the accrual of a liability and the ability to determine the amount of the liability with reasonable accuracy. The same holds true with regard to income. Taypayers on the accrual basis must report income when the right to the income accrues, although payment may not be received until much later. Yet, the accrual accounting rules do not provide for any present value discount.

In addition, other sections of the Code provide for deductions for future expenses without taking into account present value. For example, §166(c) permits a deduction for a "reasonable addition to a reserve for bad debts". The regulations under §166 provide for deductions based on reasonable estimates.

Another point raised by the Treasury is that the proposed rule is difficult to administer since the estimates of future expenses are inherently uncertain. It is submitted that the

safe harbor provision discussed in our testimony would eliminate the uncertainties inherent in a "reasonable estimate" test, while at the same time providing safeguards for overstating reclamation costs due to the higher bond which must be filed.

With regard to the third point made by Treasury, that the revenue loss would be prohibitive if applied to all similarly situated taxpayers, it is obvious that if such legislation were applicable to all industries for all future costs, the revenue loss would in fact be prohibitive. However, this is a bill which provides relief for a depressed industry, and there is no requirement that it be done in every industry. This bill deals with a rather unique situation involving legislatively mandated future costs directly attributable to current income-producing activities.

In conclusion, we hope the committee will support this bill. It provides vital relief for the economically besieged coal industry at a time when weak domestic and international markets and increased regulatory costs have cast a dark cloud over the industry. However, we urge the committee to implement the natural safe harbor provision provided by Section 508 of SMCRA in order to prevent litigation and unnecessary burdens on the courts, IRS, and the taxpayers that have prevailed in the past.

Mr. Chairman, I am also here today to announce the unqualified support of the Pennsylvania Coal Mining Association for S. 1006.

S. 1006 was introduced on April 7, 1983 by Senator Spector. The Association wishes to place on the record its sincere

appreciation for Senator Spector's initiative in this regard. It is typical of the Senator's long standing support of our industry.

S. 1006 will eliminate the scheduled fifteen percent (15%) reduction in the depletion for coal and iron ore. This measure is absolutely essential to allow the coal industry in Pennsylvania to struggle back on its feet.

In his insightful remarks introducing S. 1006, Senator Spector noted that the coal industry was operating at 67 percent of capacity. While this may be accurate as a national average, I respectfully submit it is substantially overstated for the rural areas of central and western Pennsylvania where many of our finest and oldest companies are now operating at zero capacity. Many are shut down and their employees are laid off. While the thrust of the 15% reduction in deductions as provided in Code section 291 enacted under TEFRA was to reduce special tax benefits flowing to taxpayers receiving other tax benefits such as financial institutions, these other taxpayers who were the focus of section 291 were not in the depressed economic state as one now finds the coal industry. Thus, it is neither unfair nor unwise to reverse the 15% reduction scheduled for next year.

In conclusion, I wish to once again thank Senator Spector for his help and initiative in introducing S. 1006, and even more recently his introduction of S. 1307, which is not before you at the present time.

Thank you for time, attention and consideration. I will be happy to answer any questions you may have.

Senator WALLOP. Thank you.
Mr. Turnock?

STATEMENT OF LAWRENCE J. TURNOCK, PRESIDENT, AMERICAN IRON ORE ASSOCIATION, ACCOMPANIED BY JOHN L. KELLEY, CHAIRMAN, TAX COMMITTEE

Mr. TURNOCK. Mr. Chairman, I am Lawrence Turnock. I am president of the American Iron Ore Association. I am accompanied by John L. Kelley, chairman of our association's tax committee. He is also vice president for tax and government relations for Cleveland Cliffs Iron Co.

Our testimony today is limited to support of Senator Specter's proposal to repeal the 15-percent reduction in percentage depletion for iron ore. Although we are not presenting testimony with respect to Chairman Wallop's mining reclamation bill, we do concur with the views on this subject being expressed to you by the American Mining Congress.

We commend Senator Specter, who, with your support, took the initiative in 1982 to prevent the enactment of this reduction and promptly introduced his repeal proposal in the 98th Congress. We also appreciate, Senator Wallop, your recognition of the need to invite public testimony on, and your support of, Senator Specter's proposal.

We submit to you that there is no justification for the cutback in the percentage depletion deduction. It should be repealed, and for the following four reasons.

First, no supportable basis exists for a distinction in terms of percentage depletion deduction between producers of other minerals and producers of coal and iron ore. The scheduled depletion reduction for coal and iron ore producers appears to have been enacted because of a tax provision that applies only to qualifying owners of domestic coal and iron ore deposits who receive royalty income in return for the disposal of their mineral deposits. This capital disposition provision is not applicable to producers in that percentage depletion deduction is not allowable with respect to such royalty income. Thus, the sales proceeds from all minerals from a property must be reduced by royalty payments in arriving at the gross income upon which percentage depletion is computed. Given this common tax treatment among all mineral producers, there is no technical justification in our opinion to support a cutback of the percentage depletion deduction only for coal and iron ore.

Second, in 1973, the National Commission on Materials Policy recommended that percentage depletion be continued as an incentive to discovery and development of mineral resources. We contend that there exists today an even greater need for retention of the full percentage depletion allowance for iron ore. It is our conviction that it remains in the national interest to maintain a strong and dependable domestic iron ore industry and to insure that employment opportunities in this portion of the private sector are not dissipated.

Deposits of iron ore in the United States are of relatively low grade compared to those throughout the rest of the world, yet the industry has in the past decade made extensive investments in do-

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mestic processing facilities and infrastructure. Today, these investments are threatened by the involvement of other governments in the expansion of foreign productive capacity, without regard to conventional economic criteria. U.S. Government encouragement at this time would be a most welcome sign.

Third, the iron ore mining industry has been severely hurt in 1982. It appears that in 1983 plant utilization will not exceed 50 percent, nor will the industry unemployment level fall below 50 percent. Legislation which impairs a longstanding incentive to the iron ore industry is not, in our judgment, a fitting signal from Government as to the direction of its tax policy.

Fourth, it is our contention that the trend begun in 1969 to expand the preference concept to corporations is a serious detriment to the evolution of sound tax principles. It is creating a complicated and unnecessary tax structure within the tax structure. Senator Specter's proposal would eliminate a part of this unnecessary structure.

In closing, we respectfully uge you to support Senator Specter's proposal. It reflects sound tax policy and contains an encouraging signal to a severely battered iron ore industry.

[The prepared statement of Mr. Turnock follows:]

AMERICAN IRON ORE ASSOCIATION

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Statement
of

AMERICAN IRON ORE ASSOCIATION

by
Lawrence C. Turnock, President

to the
Subcommittee on Energy and Agricultural Taxation
(UNITED STATES SENATE-COMMITTEE ON FINANCE)

May 23, 1983

Mr. Chairman and other distinguished members of the Subcommittee. My name is Lawrence C. Turnock. I am President of American Iron Ore Association. I am accompanied by John L. Kelley, Chairman of the Association's Tax Committee, who is also Vice President-Tax and Government Relations for The Cleveland-Cliffs Iron Company. Our association, which has its headquarters in Cleveland, Ohio, is a trade organization representing companies that mine about 75 percent of the iron ore produced in the United States and Canada, as well as a substantial portion of the iron ore produced in the free world.

Our testimony today is limited to Senator Arlen Specter's proposal to repeal the 15 percent reduction in percentage depletion for iron ore (S. 1006). Unless repealed as proposed by Senator Specter, a 1982 enactment to take effect in 1984 will require affected taxpayers to reduce their otherwise allowable deductions for iron ore percentage depletion by 15 percent. Although we are not presenting testimony with respect to Chairman Wallop's mining reclamation bill (S. 237), we do concur with the views on this subject being expressed to you by American Mining Congress.

The American Iron Ore Association understands that the cutback in the percentage depletion deduction, as provided for by the Tax Equity and Fiscal Responsibility Act of 1982 was rationalized on the premise that it would bring about a more equitable tax treatment among all mineral producers. Given the

circumstances under which many decisions had to be made with regard to the 1982 Act, we can certainly understand why the enactment appeared to be reasonable at the time. But we submit to you that this provision was founded upon a misconception. Consequently, there is no justification for the cutback, and it should not have been enacted.

The American Iron Ore Association is testifying that the 1982 cutback enactment should be repealed before it becomes effective next year. We admire the insight and fortitude of Senator Specter who took the initiative---against overwhelming odds and momentum on the Senate floor---to prevent the unwarranted and inequitable 1982 enactment in the first place. With cooperation of the Senate, he was able to obtain a one-year deferral of the effective date. And he has demonstrated an impressive degree of perseverance in his prompt introduction of S. 1006 in the 98th Congress. We believe he championed a just cause. We want to express our appreciation as well to Chairman Wallop for recognizing the need at this time to invite public testimony on Senator Specter's proposal and for his recognition of the serious national problems which are arising because of the adverse economic conditions throughout the mining industry.

We offer the following reasons in support of S. 1006 which would repeal the 15 percent reduction of iron ore percentage depletion.

First, no supportable basis exists for a distinction in terms of an allowable tax deduction between producers of other minerals (extraction of which continues under the 1982 Act to qualify for the full percentage depletion allowance) and producers of coal and iron ore. The scheduled reduction for coal and iron ore operators, appears to have been put in place because of a tax provision that applies only to certain non-operator/owners of domestic coal and iron ore properties. Such non-operator/owners, who meet the required statutory holding period and who dispose of their deposits by means of a lease contract while retaining an economic interest in the mineral in place, must report their royalty payments as long-term capital

gain income. No percentage depletion deduction is allowable with respect to such royalty income. Nor is this tax provision applicable to the operator on his direct sales proceeds from the mineral, even if the operator is also the fee owner of the mineral property. Moreover, to the extent any mineral operator is obliged to pay royalties to an owner/lessor, his gross sales proceeds must be reduced by such royalty obligations in arriving at gross income from the property to compute percentage depletion.

It is our belief that this sharing of mineral revenues between operators and owner/lessors was not thoroughly considered during the 1982 deliberations. Percentage depletion calculations are made with respect to all minerals by qualifying operators only after revenues from minerals have been reduced, dollar-for-dollar, by royalties paid, without regard to the character of those payments in the hands of the payees. Given this common tax treatment among all mineral operators, there is no technical justification to support a reduction of the percentage depletion deduction for coal and iron ore.

Second, it is our conviction that it remains in the national interest to maintain a strong and dependable domestic iron ore industry and to insure that employment opportunities in this portion of the private sector are not dissipated. Although there are many factors that contribute to these objectives, it is critical that stability in our tax laws is assured so that decision-makers in industry will retain the necessary confidence to make the long-term economic commitments that are inherently a part of iron ore mining.

Deposits of iron ore in the United States are of relatively low grade compared to deposits throughout the rest of the world. Yet the industry has recently committed itself to extensive permanent investments in domestic processing facilities and considerable infrastructure. Today, the future of these investments is very uncertain due to many external factors, not the least of which is the involvement of other governments in the expansion of foreign productive capacity

without regard to conventional economic criteria. Solutions to the many adverse circumstances that plague our iron ore industry are not simple or unitary, but they must be found. The attitude of our government must be positive, appropriate government cooperation is needed, and the availability of tax incentives is vital. In 1973 the National Commission on Materials Policy recommended that percentage depletion be continued as an incentive to discovery and development of mineral resources. We contend that there exists today an even greater need for retention of the full percentage depletion allowance for iron ore.

Third, the iron ore mining industry in particular was severely hurt by the economic conditions that devastated the steel industry in 1982, and it continues to struggle toward recovery from its most severe battering since the 1930s. Senator Specter mentioned the low utilization of capacity and the high unemployment levels of the iron ore industry when he introduced S. 1006 on April 7, 1983. Although there are some signs of recovery in the economy, very little improvement in the appalling iron ore industry statistics has emerged during the past month, and projected levels of finished steel shipments for the remainder of 1983 offer little cause for optimism in the forseeable future. We have found iron ore industry statistics to be elusive and difficult to translate because of plant closings and production "bursts" at various plants to improve economics. But it appears as though plant utilization in our industry for all of 1983 will not exceed 50 percent nor will our industry unemployment level fall below 50 percent.

Many taxpayers within the industry have accumulated unused and presently unusable operating loss carryovers and investment tax credits. Necessary capital expenditures under present economic circumstances are being curtailed because of inadequate cash flow, and the repeal of safe harbor leasing has further compounded this problem.

As we are now continuing to persevere through a readjustment period, it is anticipated that our iron ore industry will experience economic health once again and be in a position to generate much needed cash flow through tax incentives. Although the percentage depletion cutback is understood to have a very minor impact on overall Treasury revenues and is certain to have a varying impact among affected corporate taxpayers (depending on whether the minimum tax applies), there is a regrettable irony in the fact that 1984 could very well be a year of turnaround. A tax policy reversal at this time, which impairs to any extent a long-standing incentive to the iron ore industry is definitely not, in our judgment, a fitting type of signal from government as to tax policy direction.

Fourth, it is our contention that continued allegiance to the so-called "preference" concept, as it is being applied to corporations in the active conduct of business, represents a perpetuation of bad tax policy which began in 1969 with enactment of the add-on corporate minimum tax. Our position on this subject has been expressed many times in both houses of Congress. We were stunned that the 1982 Act expanded rather than curtailed the preference theme for necessary business tax incentives. Not only is there an unwarranted tax and economic penalty being placed upon vital, capital intensive, basic industries, but there has also developed a gradual move without pertinent public hearings toward an indirect repeal of many valid income tax incentives that originally were enacted to satisfy particular national objectives. This trend is a serious detriment to the thoughtful evolution of sound tax principles, and in addition, is creating an increasingly complicated and completely unnecessary tax structure within a tax structure.

Not only should there be prompt enactment of Senator Specter's bill to achieve the goal of preserving the status quo among all hard-pressed mineral operators, but priority attention should also be given to complete repeal of the add-on corporate minimum tax as well.

Senator WALLOP. Thank you, Mr. Turnock.

Mr. Nicholls, in your testimony, you have suggested that the bill should make it clear that estimates based on current accounting, mining, and industrial engineering practices be deemed reasonable. Why do you feel that is necessary?

Mr. NICHOLLS. Basically, I believe that Treasury will attack our ability to reasonable estimate. If there is not attack directly in the bill, I fear the IRS will try to set very rigid guidelines as to how you must make the estimate to qualify for the deduction. I know that within the industry, our mining conditions are different and in-house expertises may run to engineering, operations or cost accounting. In our case we are blending the engineering and the costing expertise.

I believe if a signal is not sent to theirs that there is more than one way to handle a reasonable estimate, we will all be right back in the courtroom defending our individual methods. I think our methods must be reasonable, but I do not think they ought to be limited by another technical advice memorandum that says, you will do it this way and only this way.

Senator WALLOP. What does your company use as a basis for estimating its reclamation liability?

Mr. NICHOLLS. We do two basic things. The first is what I would call the engineering inventoring of the property. We overfly the property once every 6 months and measure from aerial photographs the property that remains disturbed. Once we get an acreage determination, we basically eliminate areas that will not be reclaimed, fire lanes, access roads, and so forth. We have a cost accounting system that keys off on equipment operating costs.

We take the historical actual time and cost to preform a reclamation function and reestimate our reclamation liability based on our current acreage disturbed, including the acres stage of completion. It is really no different than what a major earthmoving contractor does in estimating a highway job.

Senator WALLOP. You also made mention of the fact that S. 237 should be expanded to include surface impact as a result of subsurface mining or underground mining. Is that under challenge as well?

Mr. NICHOLLS. Well, I think our position is that it is not clear that the underground miner is covered. I do not know of an underground mine that does not have a preparation facility coal pads, mine roads, ponds, and so forth, and they must remove structures and reclaim the surface. Also, underground mines have what is known as a subsidence problem, which is in effect a roof fall at a later date. They have developed techniques to estimate future liability. When you end up with a hole in the ground and no more coal, very rarely do you have enough taxable income open to recover your incurred reclamation costs.

Senator WALLOP. Let me just toss one out to the panel, because I assume from the panel that you would agree with me that the mining industry is subject to sufficient requirements to establish a clear liability on the first part of the test, and the more difficult one is how you accurately determine the future liability.

You touched on it in your response, Mr. Nicholls, but you can answer it generically, but is it not true that the deduction is based

on current costs and not some future sort of predictable kind of thing, but as of today? And that is just to the panel.

Mr. BEDELL. Well, Mr. Chairman, I think you will find that mining companies do base it on today's costs, not what they expect them to be inflated or what they expect other rates to go up, and so you do not have the type of overstatement or a type of overstatement. It is today's cost. Indeed, it is an understatement of what it will actually be when the reclamation occurs.

Senator WALLOP. So you would argue, I assume, then, that there is sufficient information to accurately define a deduction on that basis.

Mr. BEDELL. Well, based upon the track record, based upon the fact that it has been done, there is a reasonable basis by past experience, by the performance bond criteria. There is a body of data out there that makes the estimate a reasonable one.

Senator WALLOP. And it is always dangerous to sort of generalize, but if you were to—with regards to the surface mining industry, how long generally between the breaking of ground and the beginning of reclamation?

Mr. PENNOYER. Senator, we in Pennsylvania have been doing major reclamation projects since 1964, when our first major backfilling law was passed, and we have pretty accurate records, and are regulated by the department of environmental resources in the State of Pennsylvania that bracket us into a very narrow range, and they make us bond sufficiently so that they feel that our costs are covered, and using those bonding costs are something that I do not see how the Treasury can really argue that could be abused, because the more we pay for bonds, the tougher it makes it on our mining costs, and we certainly do not want to increase our mining costs, because we have to stay competitive.

Senator WALLOP. My question was slightly cast in another direction. What I really was asking is, in a generalization, how long generally is it between the time you break ground in the mining process and the reclamation process actually begins?

Mr. PENNOYER. In normal mining practice, within 6 to 7 months. You are backfilling as you go along. You are—in subsequent cuts, you are already backfitting the prior land that was disturbed in your first cuts, especially in Pennsylvania, where you get into contour mining rather than the open mining of the Midwest. Pennsylvania is locked into subsequent cuts of backfilling as we go along, so there is—rarely more than 6 months goes by until the reclamation process is already started.

Mr. NICHOLLS. In Alabama, we have a four spoil bank or 6-month rule covering grading and topsoiling. These steps must have taken place within 6 months. For your hearing in December, I took my company's pure cash payments against the accrued reclamation reserve, and ignoring the fact that reclamation expenses are in our inventory, it took only 4 to 5 months to completely roll over the reclamation reserve on a cash basis.

The revenue lost to the Treasury is a lesser period, because we have about a 1- to 2-month inventory at all times on the ground and the inventory cost has its proportionate piece of reclamation cost in it. To hear the IRS talk about 7 years, they are talking about less than 10 to 15 percent of the total reclamation problem.

The 7-year problem is high wall, vegetation failure, pond treatment, and what we call terminal reclamation, the preparation facilities, the ripping out of mine roads. The majority of our cost is expended in less than 6 months.

The actual first-dollar expenditures that we have is to remove topsoil and it occurs before you ever blast. You have picked it up and moved it before you mine. Costs then is incurred incrementally through a 6-month period, 6 months of being an upper limit for 80 to 90 percent of the costs to be incurred.

Senator WALLOP. So then if you are looking at it, an interpretation of the law in the as disturbed versus as incurred interpretation, you are really not talking generally in the industry not much more than a year at the outside.

Mr. PENNOYER. That is correct.

Mr. NICHOLLS. I think a concept other than as disturbed has some real inflation accounting problems in it, in that every time we look at our historical costs, the inflation has in effect been built in for the prior period. If you relook at a total mining area, as opposed to only the disturbed area, do you allow the inflation for the total mining area to be expensed that year, or do you defer the prospective inflation. Also the disturbed method happens to match with the inventory concept of what you are doing.

I think that is something that can be worked out, but I have more trouble as an accountant, with an idea other than the disturbed method.

Senator WALLOP. Well, I can tell you one reason why if I were in the business I would not want to dally about getting it reclaimed. Congress is liable to change the law on you before you can get it done, and what today is a predictable expense tomorrow might be totally unpredictable and not worth the delay.

I do not mean by my lack of questioning on S. 1006 to indicate that I do not have an interest in it, except that I think we understand basically that it is a rather simple concept, and what is involved there. I do not think anybody argues, even including Treasury, that any great resurgence in either the iron ore industry or the coal industry has occurred in the last year, so I do not mean to slight you in any way, Mr. Turnock. I just think that we do understand that, and I think there is a pretty clear understanding of what is a fairly simple principle.

And again, I did not expect to change Treasury's mind. I could always entertain a hope like that, but one of them was testifying in another committee I had one time on estate taxes, and he was on the panel, and in response to a question the Treasury man said, well, Senator, he said, we collect taxes. That is what we do, and that is why we think the way we do.

And I am persuaded that no matter how reasonable a man is, when it comes to Treasury, there is a bug that gets stuck in the back of his ear that they can no longer think like they did before they came there, and I have been interested in the testimony of some former Treasury officials in front of this committee that were here in the Carter administration. They seemed to have a rather different view of life when they get out, but this does seem to be relatively simple, and it also seems to be at least reasonably mis-

placed on the part of Treasury as to the transferability of this concept. I think the testimony is clear on that.

So, I appreciate your coming here and giving us a hand in this this afternoon, and we will see if we cannot do a little better than we did in the lameduck.

The subcommittee stands adjourned. Thank you.

[Whereupon, at 3:15 p.m., the subcommittee was adjourned, to reconvene at the call of the Chair.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT OF SENATOR ARLEN SPECTER ON S. 1006 AND S. 1307

I am pleased to have this opportunity to testify before the Senate Finance Committee's Subcommittee on Energy and Agricultural Taxation. I commend Chairman Wallop for scheduling hearings on these bills, both of which are of substantial importance to the viability of the coal and iron ore industries.

Mr. Chairman, on April 7, 1983, I reintroduced a bill, S. 1006, to eliminate the scheduled 15% reduction in percentage depletion allowances for coal and iron ore. I feel that this action is needed in order to correct a situation that arose during consideration of the Tax Equity and Fiscal Responsibility Act of 1982. That bill, in my opinion, attempted to unfairly victimize two industries already suffering disproportionately from the recession by reducing the percentage depletion allowances 15%. During floor action on the Tax Equity Act, the Senate agreed to delay implementation of the 15% reduction for one year.

The purpose of this delaying amendment, which prevailed in conference, was to allow the coal and iron ore industries to recover from a harsh and protracted economic slump. Unfortunately, the one year that was thought to be sufficient to allow for recovery was optimistic indeed. It has been nearly a year since passage of the Tax Equity Act, but neither the coal nor the iron ore industry has experienced a sustained recovery. The industry cannot yet afford a 15% reduction in percentage depletion allowances.

Statistics gathered by my office show that the coal industry is presently enduring a 31.6% rate of unemployment, with 75,000 coal workers jobless. On April 7 when I introduced this bill, the level of unemployment was 57,000 workers, and during the debate on Tax Equity Act the level was 40,000. The coal industry is currently operating at only 66% of its capacity, compared with 80% capacity utilization when the Senate agreed to the one year delay. Metallurgical coal, which is essential to steel production, has dropped to roughly 40% capacity utilization. The coal industry has not improved. Rather it has deteriorated further, and clearly does not merit any reduction in its percentage depletion allowance.

With respect to the iron ore industry, we are talking about an industry with over two-thirds of its entire work force laid off, with an estimated 11,300 hourly rated iron ore workers unemployed. Although iron ore capacity utilization has improved since passage of the one year delay, a rise of 10% in capacity utilization to 25% hardly resembles a recovery. To allow this 15% reduction in the percentage depletion allowance may stifle what little resurgence the industry has experienced, and would certainly not aid in the rehiring of laid-off workers.

I cannot think of a worse time to implement this reduction in percentage depletion. Further taxation of these industries may jeopardize not only their recovery efforts, but the viability of related industries as well. With coal and iron ore being vital components of our basic infrastructure and defense needs, I urge the Subcommittee to act quickly and favorably on this bill.

I would now like to turn the Subcommittee's attention to the Mining Reclamation bills. Senator Wallop introduced S. 237 on January 27, 1983. My bill, S. 1307, was introduced on May 18, 1983. Both of these bills attempt to accomplish the same goal, that of allowing surface mine operators to deduct the cost of land reclamation at the time the money is set aside for future use, rather than at the time the reclamation actually occurs.

Federal law requires that surface mine operators set aside the estimated costs of reclaiming the land over the productive years of the mine. This law ensures that when production stops, sufficient money is available to restore the land to its original condition. Mining concerns would very much like to deduct the money the law requires to be set aside under the existing tax laws for accrued expenses. In the 1950s, the Third and Fourth Circuit Courts of Appeal concluded that such deductions were valid in certain circumstances. The Internal Revenue Service (IRS) has refused to follow these decisions and insists that deductions for reclamation expenses not be deducted until the actual reclamation begins.

More recently, in December 1982, the Tax Court in Ohio River Collieries v. Commissioner held that if the expenses are required by state or federal law and if the amount of expenses can be reasonably estimated, then the deduction is permitted. The IRS did not appeal this ruling nor did it agree to abide by it in future cases. As a result, unnecessary litigation

will continue over the tax treatment of these funds. These bills attempt to clarify existing law.

If this mining reclamation provision is enacted, the IRS will not be able to disallow the natural and preferable tax treatment of reclamation costs. The mining operators in my state tell me that deducting these costs will help them survive the current economic hardships that have befallen the coal industry.

I urge this Committee to take prompt action to approve both the coal and iron ore depletion bill and the mining reclamation bill in order to help restore the vitality of the steel, coal and iron ore industries.

American Iron and Steel Institute

STATEMENT

OF

AMERICAN IRON AND STEEL INSTITUTE

Submitted for the

Record of the Hearing on

S. 237 and S. 1006

Before the

Subcommittee on Energy and Agricultural Taxation

Committee on Finance

United States Senate

Held on

May 23, 1983

American Iron and Steel Institute

This statement is being submitted by the American Iron and Steel Institute (AISI) for the record of the hearing held by the Senate Finance Subcommittee on Energy and Agricultural Taxation on S. 237 and S. 1006.

AISI is the principal trade association for the iron and steel industry. It represents 63 domestic producers, which account for about 89 percent of the raw steel produced in the United States.

AISI is generally supportive of the intent of S. 237 which would recognize in specific statutory terms the broad authority which we believe already exists in the Internal Revenue Code for the accrual and deduction of future land reclamation expenses. Indeed, the courts have been far more willing than the Internal Revenue Service over the years to accept the concept of current deductibility for known future expenses where the fact of the liability has been established. S. 237 would essentially codify the Tax Court's 1981 decision in the Ohio River Collieries case which specifically permitted a deduction for future surface mining reclamation costs at the time the overburden was removed.

S. 237 and previous bills introduced by Senators Wallop, Symms, Specter, Byrd and other Members of Congress have all been tied to the specific reclamation requirements of the Surface Mining Control and Reclamation Act of 1977. We would remind the members of the subcommittee that the same Act also mandated that rules be adopted to deal with the disruption of the land surface which is caused by the underground mining of coal. In fact, the operator of an underground coal mine must submit plans to deal with twelve specific items at the expiration of the mining activities in order to get a permit to mine.

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We respectfully request that this subcommittee consider amending S. 237 to include a current deduction for the future cost of restoration associated with those twelve items which are specifically covered in the statute.

We understand that the estimated revenue impact of various proposals similar to S. 237 in the past have been nominal - generally less than $15 million annually. We believe that if the bill were to be amended to include the future restoration expenses associated with underground coal mining, the revenue impact would not be increased in any significant amount since the surface disruption associated with underground mining is generally much less than that associated with surface mining.

We are completely in support of Senator Specter's bill (S. 1006) to repeal the 15% reduction in percentage depletion for iron ore and coal which is scheduled to take effect in 1984. This would make permanent the Senator's amendment to TEFRA which provided only for a one year deferral in the implementation of the provision. In dealing with the tax preference cutback concept in TEFRA, it was decided not to reduce the percentage depletion rate for most hard minerals. This did not extend to coal and iron ore depletion presumably because it was thought that these minerals already enjoyed preferential treatment under the provisions of Section 631(c). The provisions of that section apply only to the owner of the mineral, and under the same section the owner is specifically not entitled to the percentage depletion deduction provided in Section 613. Therefore, the operators of coal or iron ore mines who are entitled to the allowance for percentage depletion, but not the provisions of Section 631(c), have been singled out among all hard mineral miners for a reduction in

their percentage depletion allowance without real justification. Senator Specter's bill would merely restore coal and iron ore depletion to the same status as other hard minerals. We appreciate the Senator's efforts to restore equity in this provision and to remove a specific cost to the domestic steel industry.

Deloitte
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Mr. Roderick A. DeArment
Chief Counsel, Committee on Finance
Room SD-221, Dirksen Senate Office Bldg.
Washington, D.C. 20510

May 26, 1983

Dear Mr. DeArment:

We are pleased to have the opportunity to comment on Senate Bill 237, presently under consideration by the Senate Finance Committee. Deloitte Haskins & Sells, an international accounting firm, has extensive experience in serving the mining industry.

We believe this bill provides much needed codification of rules for determining the proper taxable years in which mineral-extracting taxpayers may deduct reclamation costs. Senate Bill 237 would allow taxpayers to choose between two methods for deducting reclamation costs. The first method would allow a deduction for reasonable estimates of reclamation costs allocable to minerals extracted by surface mining activities before the close of the taxable year. The second method would allow a deduction for reasonable estimates for reclamation costs allocable to the portion of the property disturbed by surface mining before the close of the taxable year.

We favor the passage of Senate Bill 237 because:

- the Treasury's own regulations provide for the deductibility of properly accruable expenses,

- courts have overturned Treasury attempts to disallow deductions for accrued reclamation costs,

- the concern over restoration of the natural environment has led to legislation requiring those in the extractive industries to restore the landscape altered by extractive processes. This tax legislation would assist the extractive industries to be more certain of their ability to comply, and

- the nation's stability and security is well served by measures which allow the mining industry to maintain its viability.

We favor Senate Bill 237 because of the added flexibility it would offer taxpayers in calculating their deduction for reclamation costs. The method under Senate Bill 237 allowing a taxpayer an option to deduct reclamation costs at the beginning of a mining project when property is disturbed would be similar to provisions under section 616, IRC, which allow a current deduction for mine development costs, unless an election is made to capitalize such costs. In addition, Senate Bill 237 would allow a taxpayer to deduct reclamation costs at the point in time when the liability for those costs is incurred (that is, as soon as land is disturbed), which is the proper time for accrual-basis taxpayers to deduct these costs according to existing Treasury regulations and court cases.

The Treasury regulations provide two tests which must be met for an accrual-basis taxpayer to accrue an expense for tax purposes. First, all the events which establish the fact of the liability must have occurred in the taxable year when the deduction is sought. Second, the amount of the

liability must be determined with reasonable accuracy. With regard to reclamation expenses, in most cases both these tests are met before the reclamation process actually takes place.

Most mineral-extracting taxpayers are strictly bound by state statutes to restore any land on which they mine to its original (sometimes better-than-original) condition. Usually the taxpayer is required to make very extensive estimates of the reclamation costs. In most cases the taxpayer must post bonds for performance of the reclamation requirements and must remain liable for additional costs over and above the bonds posted. If the taxpayer fails to comply with the requirements of the statute, the state usually has the authority to discontinue the taxpayer's extractive operations.

In addition to state reclamation statutes, the Federal government has enacted the Surface Mining Control and Reclamation Act of 1977. This Act provides for the cooperation between the Secretary of Interior and the states with respect to regulation of surface coal mining operations. The Act provides that the primary responsibility for controlling the reclamation operations lies with the individual states. However, if the states fail to carry out this responsibility, the Act grants the Federal Government the power to ensure the protection of the public interest through control of surface mining operations.

Because of such legislation, it is clear that mining taxpayers incur a definite, unavoidable obligation, or liability, to restore any land that has been altered by their extraction operations. Such liability occurs as soon as the land has been disturbed. Even if the taxpayer ends

up not mining any mineral, or after mining, is unable to sell any mineral, the liability is still there to incur the reclamation costs.

With respect to the second test, it is a question of fact as to whether the amount of the expense can be deterined with reasonable accuracy, the regulations provide that the portion which can be determined with reasonable accuracy is accruable. These bills would provide for deduction of expenses which can be estimated with reasonable accuracy.

In past situations where the Internal Revenue Service has challenged a deduction for accrued reclamation costs, the courts have agreed with the mineral-extracting taxpayer that the requirements of the Treasury regulations were met, provided the liability was fixed and the taxpayer used diligent methods of estimating the costs. The Treasury's position in attempting to disallow reclamation expenses is inconsistent with their own regulations and results in arbitrarily imposing cash-basis accounting on accrual-basis taxpayers. Nonetheless, the Internal Revenue Service has continued to challenge taxpayers' deductions for accrued reclamation costs, thereby creating a controversy concerning the proper time for deducting these costs.

This controversy has created an atmosphere of uncertainty in planning mining projects, which has undermined the economic health of an industry which already has been hard hit by the recent economic recession. By its very nature, our nation's mining industry is a very high-risk business requiring substantial capital outlays at the front end of its mining projects. Normally there is a significant development phase before any of the capital outlays can be recouped from mineral sales. These high initial capital requirements

coupled with a long lag time before minerals are sold causes severe cash flow shortages in the mining industry. In addition, recent high interest rates have placed further cash flow burdens on mining taxpayers causing numerous companies to shut down operations. Senate Bill 237 would eliminate the controversy surrounding the proper time for deducting reclamation costs, thereby reducing the uncertainties associated with planning mining projects, which will in turn help stimulate economic recovery in this industry. We also believe Senate Bill 237 would help alleviate the depressed state of our nation's mining industry by allowing taxpayers to offset the risks associated with investing in mining operations by the increased cash flow which will result from the reclamation deductions provided in this Bill.

At hearings on December 7, 1982, and May 23, 1983, the Treasury presented the view that an accrual deduction is unfair because it gives the taxpayer the benefit of a deduction prior to the outlay of cash and made arguments based upon time-value of money and discounted cash flow projections. Such an argument runs contrary to the theory of accrual tax accounting and the whole thrust of the Internal Revenue Code. Under the current law, taxpayers must in many instances recognize income prior to receipt. In addition they are precluded from immediate deduction for expenditures made; for example, machinery and equipment, buildings, and goodwill. Fixed and determinable liabilities are allowable as deductions under the Internal Revenue Code without regard to the date of payment except in special situations such as section 267.

In summary, we support the enactment of Senate Bill 237. It would eliminate the current controversy caused by the

Internal Revenue Service taking the position that is in conflict with cases and with the Treasury regulations and would provide a substantial boost to a crippled industry which supplies our nation with crucial raw minerals.

We appreciate the opportunity to be able to provide these comments to the Energy and Agricultural Taxation Subcommittee of the Senate Finance Committee and ask that they be included in the record of hearings on Senate Bill 237. Should you have any questions, please call the undersigned at 626-1925 or James R. Cummings, our National Industry Director, Energy Resources Group at (303) 534-8153.

Very truly yours,
DELOITTE HASKINS & SELLS

Alexander Zakupowsky, Jr.

bc: James Power - NEW YORK
Mark A. Forman - UNION PACIFIC CORPORATION
John Mendenhall - UNION PACIFIC CORPORATION
James Cummings - DENVER
Joseph Jeffries - AMERICAN MINING CONGRESS

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SUBMISSION BY WILLIAM F. BAUMANN
ON
S. 237
May 23, 1983

INTRODUCTION

I am Bill Baumann, General Manager of Bear Creek Uranium Company. Bear Creek is a large uranium mine and mill complex near Douglas, Wyoming, that has been operating since 1977. Bear Creek is owned equally by a utility company, Southern California Edison, and by Rocky Mountain Energy, a mining company.

These comments on S. 237 represent the views of the Wyoming Mining Association, of which I am a Director, and express my personal concerns as a miner. I feel that the reclamation issue is of vital importance to my industry. The uranium industry has been especially hard hit economically, with employment in Wyoming down 70 percent in the last few years.

After a review of the mining and milling process and the kind of work required to reclaim a mine site, it will be clear that mines face a fixed and certain reclamation obligation, established by federal and state laws and regulations. This obligation incurs clearly defined work commitments, the costs of which can be reasonably determined. The economic consequences of the reclamation obligation are an important part of any mine feasibility study and may, in fact, swing the investment decision. Legislation is needed to

codify existing case law, and thus, end costly litigation between the mining industry and the Internal Revenue Service.

Process Description

The delineation of an ore body is done with extensive drilling, which may take several years. Each drill hole must be reclaimed, and this is usually done within a few weeks or months after drilling is completed. At Bear Creek, we have so far identified 11 separate ore bodies.

Mining starts with removal of the topsoil over the ore body. The topsoil must eventually be replaced, so it is carefully stockpiled. The topsoil piles must be contoured to blend with the surrounding terrain and then vegetated. Picture #1, in the book of illustrations, shows topsoil being hauled to a stockpile. Picture #2 shows such a topsoil pile that has been vegetated.

Next, the material overlying the ore body must be removed. This overburden may be a very large volume requiring months or even years to completely remove. The material is either stockpiled on the surface, to be eventually replaced, or used to backfill another pit that has already been fully mined. Picture #3 shows overburden removal in progress. At Bear Creek, we use a large 17 cubic-yard electric shovel that loads 120-ton trucks.

After the ore is exposed, mining is done, as shown by Picture #4. You can see that a typical pit at Bear Creek is quite large. The volume of ore to be mined is small compared with overburden, but the mining is much more selective and is done with

smaller equipment. It may take 6 to 12 months to mine out a typical pit at Bear Creek.

The ore is hauled to a mill where it is processed into uranium oxide, our commercial product. The milling process results in waste material, called tailing, which is placed into a containment basin, shown in Picture #5. The mill's life may be 15 to 25 or 30 years. When the containment basin is filled, it must be covered with a thick layer of protective material, usually clay, and then contoured and vegetated. The mill, at the end of its life, must be decontaminated, disassembled, removed, and the site restored to its original conditions. Also, other site facilities, including offices and maintenance buildings, and site access and haul roads must be fully reclaimed.

In general, each mined-out pit must be completely refilled. At Bear Creek, we try to plan our operations so that an empty pit can be filled with the overburden being removed from another pit. This is usually less expensive than rehandling material from surface stockpiles. Often surface stockpiles must still be used, however, because ore bodies are too far apart. And, of course, the final pit or pits of any project must be backfilled from surface stockpiles. Picture #6 shows one of our 120-ton overburden trucks backfilling a mined-out pit.

After the pit is filled, the original topsoil is taken from its stockpiles and replaced. Then the area is returned to its approximate original contours and seeded, as shown in Picture #7.

To gain an impression of the magnitude of the mine reclamation job, please compare Pictures #8 and #9. Picture #8 shows an aerial view of some of the mining activity at Bear Creek.

As you can see, the disturbed acreage is sizeable. In the foreground of the photo is a reclaimed stockpile. Picture #9 is a close up of one pit area that has been completely reclaimed. The landscape has been returned to its natural state, and native flora has been reestablished.

Timing and Cost

The time required for the pit reclamation process described depends on the size of the ore body. At Bear Creek, a typical ore body might take three to five years from initial topsoil removal to final reclamation.

The exact life of Bear Creek, however, is uncertain. Existing contracts will expire in 1989. Spot market sales or new contracts might extend the operations beyond that time. On the other hand, our current contracts allow the customers to terminate at any time under certain conditions involving unfavorable prices.

If our production operations should prematurely cease, we must begin full site reclamation including reclamation of whatever pits are open. An independent engineering consultant has estimated that such reclamation would take about five years to complete.

Source of the Reclamation Obligation

The reclamation obligation is fixed by federal and state laws and regulations and by regulators' interpretations of these statutes. To obtain a permit to mine any ore body in Wyoming, for example, the miner must first prepare a comprehensive reclamation plan and have it accepted by the Wyoming Department of Environmental Quality (the DEQ). A mill and tailing containment area must also

be covered by an acceptable reclamation plan before being permitted by the U. S. Nuclear Regulatory Commission. If federal acreage is involved on a project, the U. S. Forest Service and the U. S. Geological Survey may also require reclamation plans.

A project must assure its compliance with these plans by posting a performance bond. In Wyoming just last year, however, some allowance has been made for self-bonding by companies that can demonstrate sufficient financial strength.

Annually, the project must report its reclamation status and progress to the Wyoming DEQ. The site is also subject to periodic inspections by state and federal regulators. Civil and criminal sanctions exist for noncompliance.

Determination of the Liability

The reclamation liability exists the moment the land is disturbed. The project has an immediate, legal obligation to restore the site per the approved reclamation plans. The greater the disturbance, the greater the liability.

The cost of the reclamation liability can be reasonably determined. At Bear Creek, we employ a well known engineering consultant, Chapman, Wood, and Griswold, Inc., to annually determine our liability. The consultant calculates the cost and time to fully reclaim the project, all according to sound engineering principles and practices. Such calculations are comparable to those that an independent party would use for negotiating an arms-length agreement to perform the reclamation work under contract with Bear Creek. Our own engineers, of course, keep track of disturbance and reclamation on an ongoing basis, in accordance with our reporting requirements to governmental agencies.

Investment Decisions

The tax treatment of the reclamation liability is an important part of the decision whether to enter a mining investment. The uncertainty surrounding the Internal Revenue Service position could negatively impact the development of new mining projects. If the financial analysis of an investment opportunity assumes that the reclamation liability is to be deducted not when it is incurred but instead when the work is performed, a significantly different present value is indicated. Such an unfavorable tax treatment can swing the investment decision negatively, causing a mine investment to be postponed or even rejected.

Need to Codify Existing Law

Current regulations support the immediate deduction of the reclamation obligation. Regulations require that, for a deduction to be made, the taxpayer establish, with reasonable accuracy, both the existence of a liability and the amount of that liability. As we have seen for Bear Creek, mines incur a federal and state statutory liability to reclaim as soon as disturbance begins. The amount of this liability at Bear Creek is calculated annually by independent professional engineers. Thus, at Bear Creek and other mines, the requirements for an immediate deduction of the reclamation liability are readily met.

However, the IRS, in interpreting these regulations, has taken a confusing and inconsistent position with respect to mine reclamation expenses. This position has not been supported by the courts, and thus, legislation is needed to codify the existing case law to avoid costly litigation in the future.

Thank you for your consideration of this submission.

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